Module 1: Purpose and Governance

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Lesson 1-1: Introduction to Purpose and Governance

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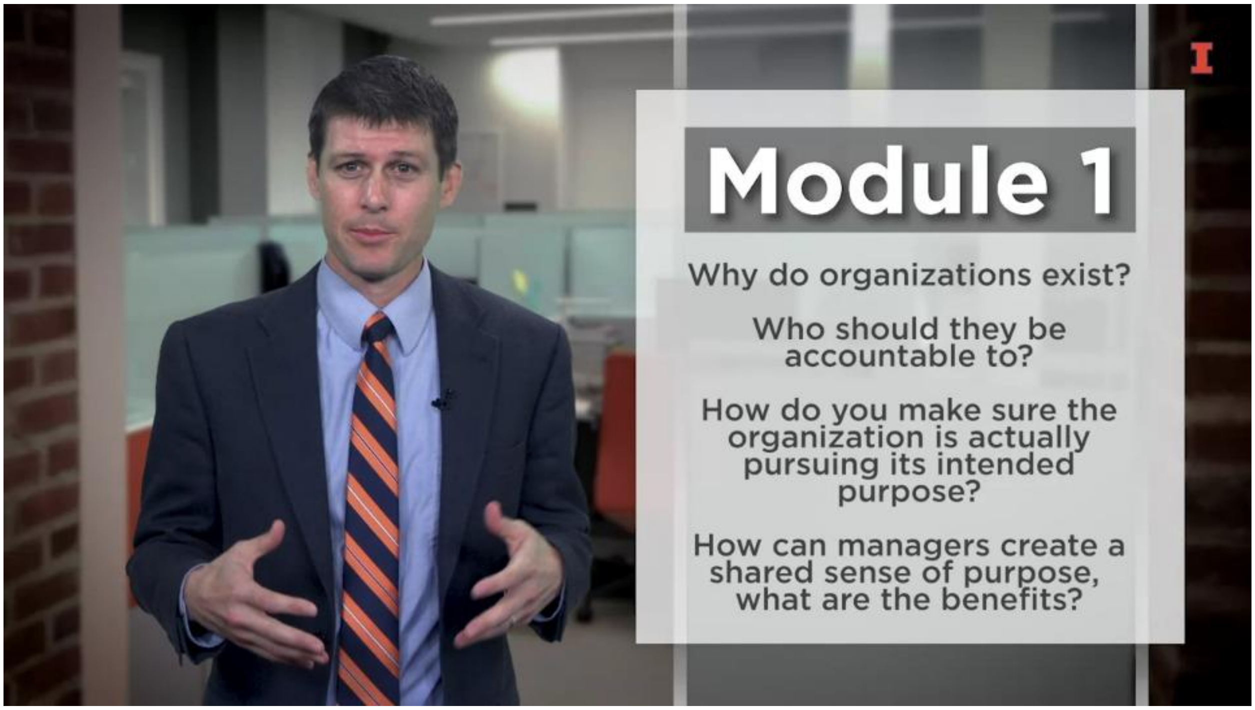


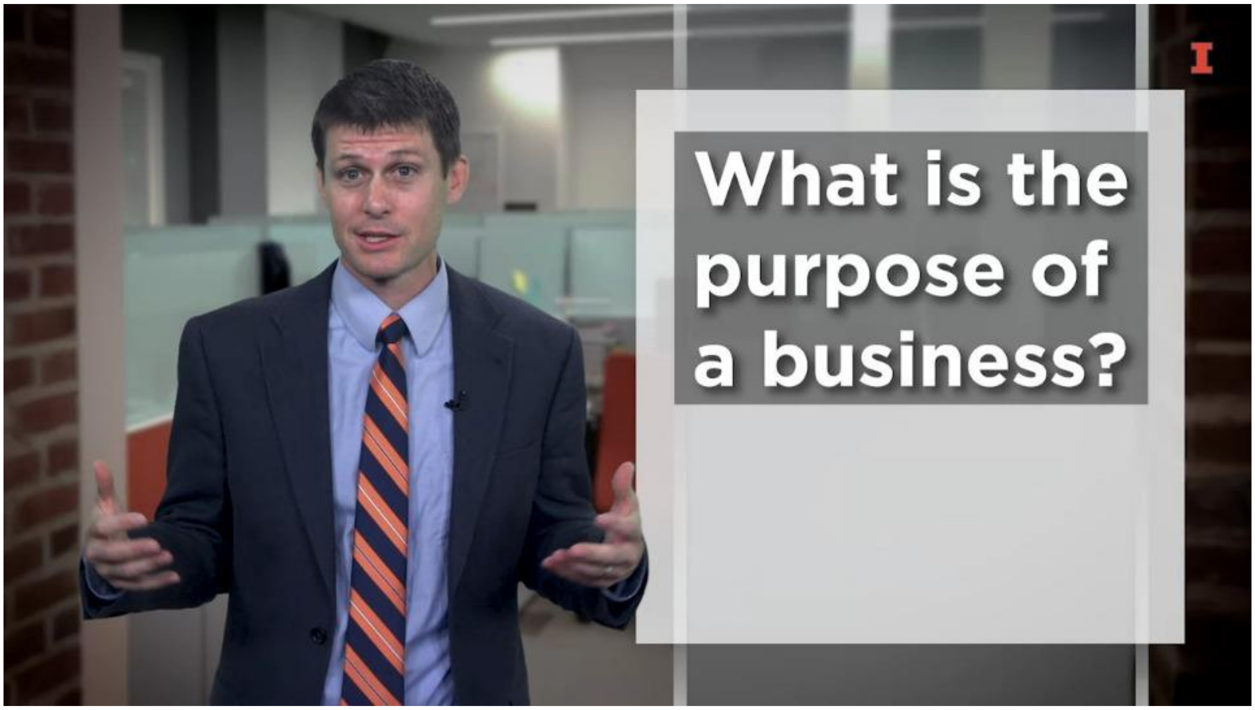
In this module, we're going to explore some foundational questions about organizations. Why do organizations exist? Who should they be accountable to? How do you make sure that your organization is actually pursuing its intended purpose? How can managers help to create a shared sense of purpose? What are the benefits of doing so? There's a good reason why we discuss these fundamental questions of organizations before diving into some of the other aspects of designing and managing organizations. Clarity of purpose is an essential element of organizational design and can help to provide guidance in all kinds of other important decisions. As a leader, part of your role is to help people connect with the larger purposes of the organization. As you help employees to find purpose in what they do each day, they're more likely to be motivated and productive and add real value to the organization.

We'll also talk about governance. When we think about governance, we often think of boardrooms, executive pay, and big strategic decisions that affect the entire organization. Sometimes we even think about big corporate scandals where managers get fired for unethical behavior or for leading the firm in the wrong direction. While all these things are all correctly associated with governance, I like to think about governance as fundamentally about two things, purpose and control.

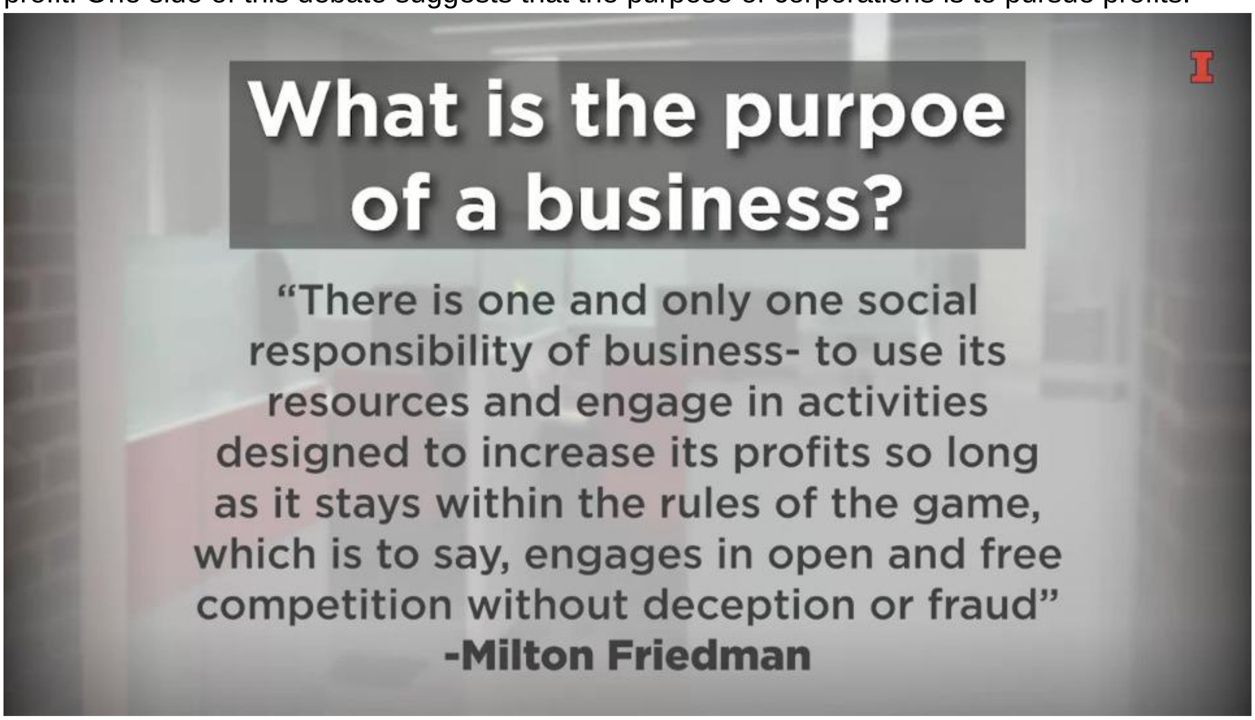
We have to decide what the purpose or purposes of the organization should be. We have to answer that important question of why do we exist? When it comes to control, we have to decide how are we going to make sure that we actually pursue those intended purposes? We have to figure out who's going to have power in the organization and how are they going to use it and be held accountable? If we think about governance as related to purpose and control, it's important for managers at all levels of the organization to be familiar with these ideas. First, it's important to know some basic things about how organizations are typically run. Some of the common governance practices and mechanisms that are typically put in place. But it's also important to remember that every manager has an opportunity to help employees see the larger purposes of what they're doing and to put in mechanisms to help them achieve those purposes. In the end, governance is really all about effective leadership, which is something that applies to all of us.

Lesson 1-2: Purpose of a Business

[Lesson 1-2.1: Purpose of a Business]



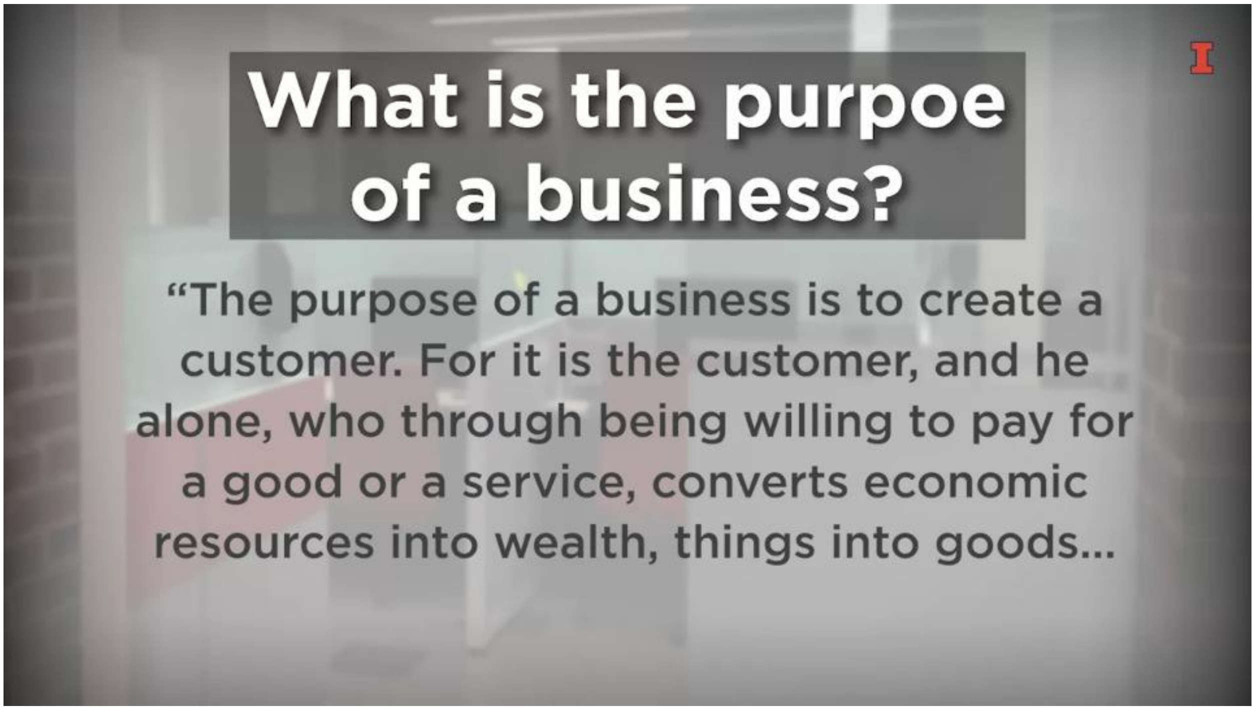
What is the purpose of a business? This is a seemingly simple question but it's actually fostered lots of debate over the years. Many times this debate is couched in terms of whether the purpose of the firm is to pursue profit or if firms have a social responsibility outside of making a profit. One side of this debate suggests that the purpose of corporations is to pursue profits.



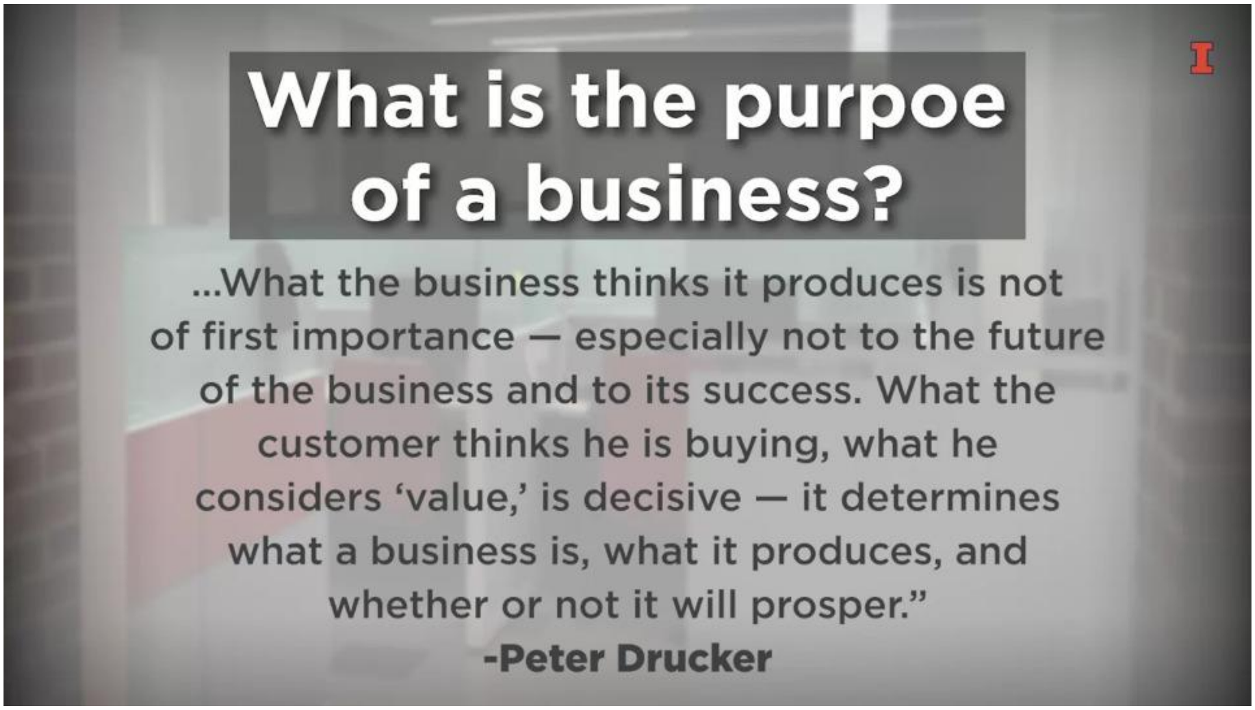
The Nobel Prize winning economist Milton Friedman once wrote that there is one and only one responsibility of business; to use its resources and engage in activities designed to increase its profits, so long as it stays within the rules of the game, which is to say it engages in open and free competition without deception or fraud.

Friedman and others have argued that corporations do the most good for society by pursuing profits because this unleashes the power of competition which leads to innovation, growth, jobs, and ultimately a more prosperous society. When business leaders pursue anything other than profits, they're taking someone else's money and using that money to pursue something that they really aren't authorized to do, like taxation without representation. Managers are agents of the owners of the firm or the shareholders, so shareholders give money to the company with the promise that they'll see a return on that investment. So as agents, managers have a responsibility to deliver on that promise rather than pursuing other interests. Friedman argued that the idea of social responsibility is really an individual level construct. Individuals rather than corporations have social responsibilities and so individuals should give of their time and resources to the social causes of their choosing. Individuals should work through the political process to enact laws that will achieve the social ends that they desire. If corporations are pursuing social ends, they may be subverting the democratic political process. Friedman also suggested that much of what business leaders call social responsibility, is simply window dressing and it's actually just catering to market demands.

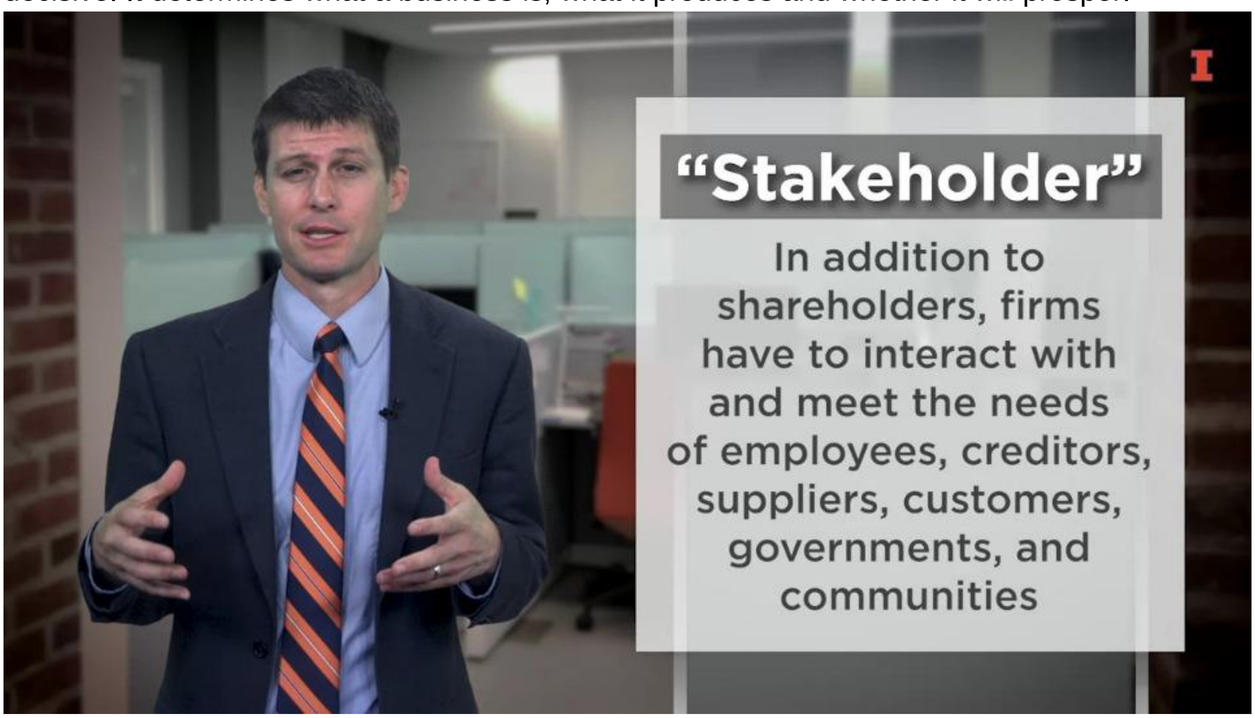
Now this type of thinking has given rise to the shareholder value perspective, the idea that businesses should be run primarily to maximize returns to shareholders. This perspective has been extremely influential over the last 50 years.



On the other side of this debate, we have those who advocate for a different or a broader view of what the purpose of a business should be. Management guru, Peter Drucker once said that the purpose of a business is to create a customer. It's the customer who determines what a business is for it is the customer and he alone, who through being willing to pay for a good or for a service converts economic resources into wealth, things into goods.



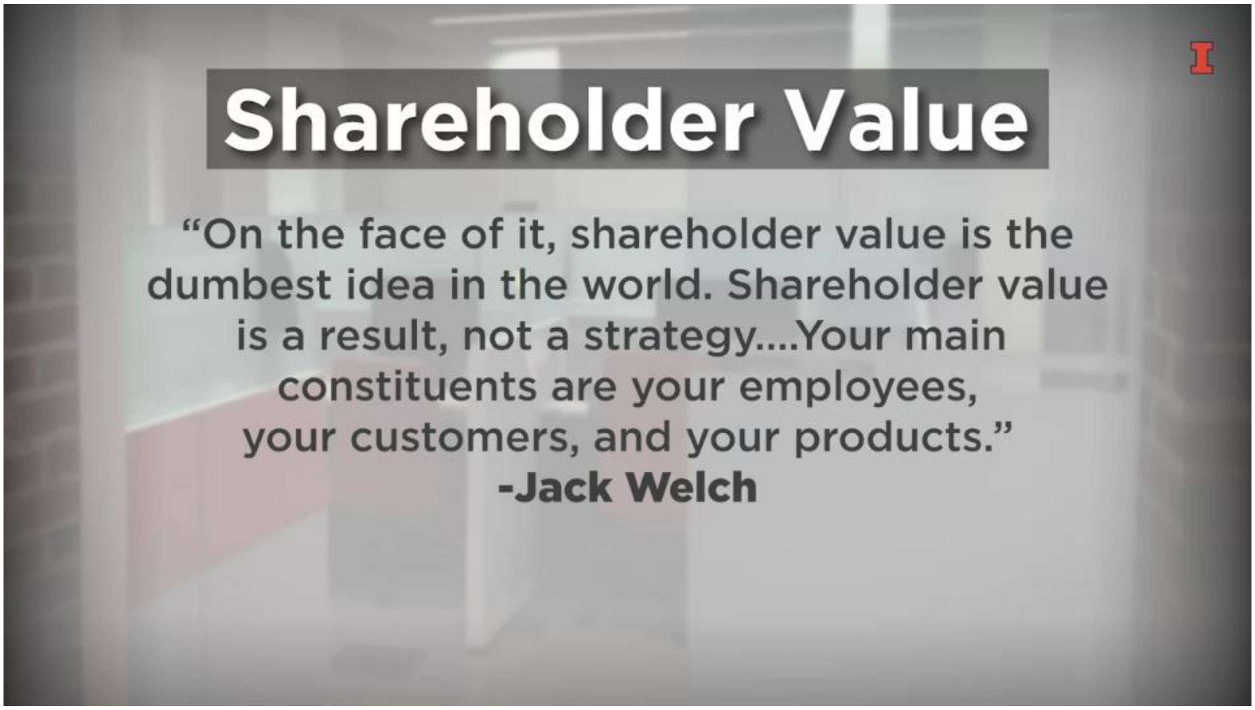
What the business thinks it produces is not a first importance, especially not to the future of the business and to its success. What the customer thinks he is buying, what he considers value is decisive. It determines what a business is, what it produces and whether it will prosper.



Others have looked even beyond customers, to what we call a stakeholder perspective. This view points out that in addition to shareholders, firms have to interact with and meet the needs of employees, creditors, suppliers, customers, governments and communities. If firms are going to deliver long-term value, they need to address the needs of this diverse group of stakeholders. This perspective suggests that profits are a means to an end rather than the end goal itself. Many have argued that firms do have social responsibilities outside of making a profit. Rather than make decisions solely for the benefit of shareholders, many of whom are short-term investors with very little interest in the long-term success of the firm, managers should make decisions that balance the needs of different constituencies.

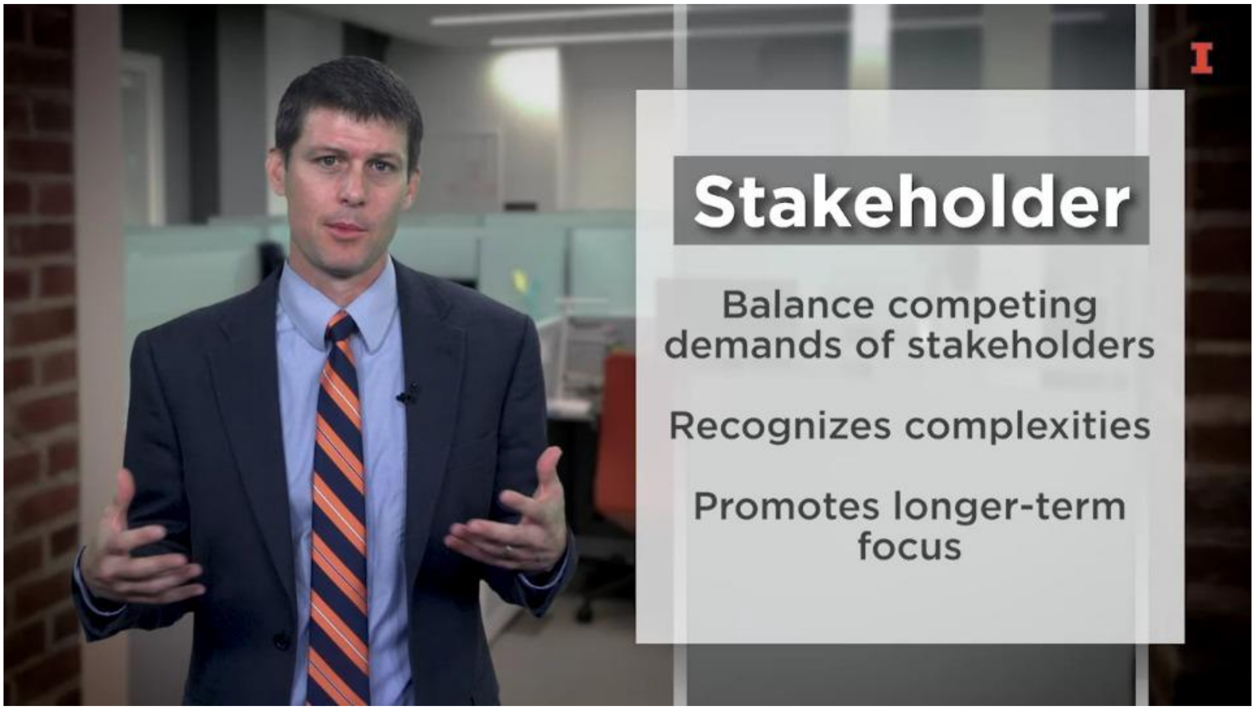
So oftentimes we see this debate between a shareholder value perspective and a stakeholder perspective.

Shareholder value gets criticized as being too narrow and leading to short-term, even myopic decision making. Even Jack Welch, the former CEO of General Electric, who is often regarded as a leader in the shareholder value movement, he once said that as he reflected on his time in corporate America,



"On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy. Your main constituencies are your employees, your customers, and your products." Now obviously, Jack Welch was not against delivering great returns to shareholders but I think he's saying something similar to Peter Drucker, that great returns are result of focusing on key constituents.

Now despite such criticism, the shareholder value perspective does provide a nice and simple metric by which we can measure success.



Now on the other side, the stakeholder value perspective, it gets criticized because it's actually really hard to give specific advice and guidance to managers about how exactly to balance the competing demands of different stakeholders. It's not always even clear who should be included as the key stakeholders and how much weight their interests' should be given but it does recognize the complexities of the many players with an interest in the firm and so it's often seen as promoting a longer-term focus among managers.

So can these perspectives be reconciled? It seems like this debate has gone on for a long time and will probably continue but I think in many ways this is a false debate, and to really get at why this is a false debate, it's useful to remember that we can think about organizations in three ways; as rational systems or as machines, as natural systems or communities of people, and as open systems or adaptive organisms.

The shareholder value perspective is really a rational system view of the organization. It treats the firm like a machine with a very well-defined goal.

Now the stakeholder perspective is more of a natural and open system view of the organization. It recognizes that there are sometimes multiple goals that the firm pursues at the same time and there are actors outside the organization that managers need to pay attention to. Now there's probably some danger in only viewing the organization through one of these lenses.

One way to think about these perspectives is that in the long run, firms are more likely to increase their profits as they consistently meet the needs of customers, employees, and other key stakeholders.

Lesson 1-3: Building Purpose Into Your Organization

[Lesson 1-3.1: Building Purpose Into Your Organization]

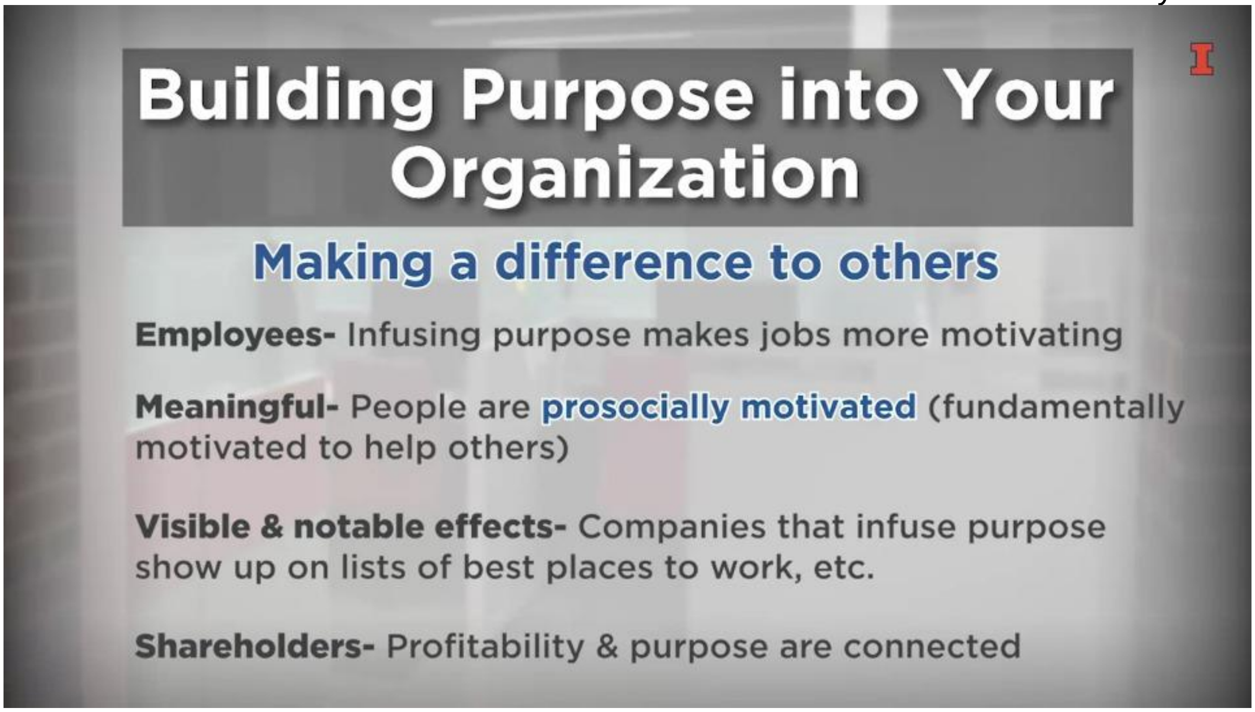
This video is about building a sense of purpose into your organization. So we'll cover what this means and why you would want to do it in the first part of this video, and then in the second part, I'll talk about how to do it. Because purpose can be appealing, but it's not necessarily easy. So before we start with this what, why and how, let's talk about the motivation. What's motivating efforts to build purpose into organizations? What problem is out there that people are trying to solve? Well, to my mind, the live motivation is that there's a lot of untapped potential in people who work in organizations. Some of this comes from people being disengaged. When people come in just for a paycheck, they're likely to lack full motivation and commitment, they're likely only to give part of their energy and their ideas. So building purpose into the organization is one way to address that, one that's the subject of much in increasing discussion. If you can succeed, it can make a difference not just for your employees, but for your customers and your shareholders. So what does it mean to build purpose into an organization? What are you actually trying to do here? What changes? What's our definition of purpose here to start?

Well, the working definition is this; we want to connect people's work to a purpose beyond their economic self-interest, in essence, a reason beyond the paycheck, for doing the organization's work. This is important because it's an accessible way of thinking about purpose. It's not necessarily noble or magnificent, like landing a man on the moon, that's something that might seem out of reach to many organizations. Now there's many ways to build this kind of a purpose. There's several things that organizations do that provide the core base for this kind of purpose.

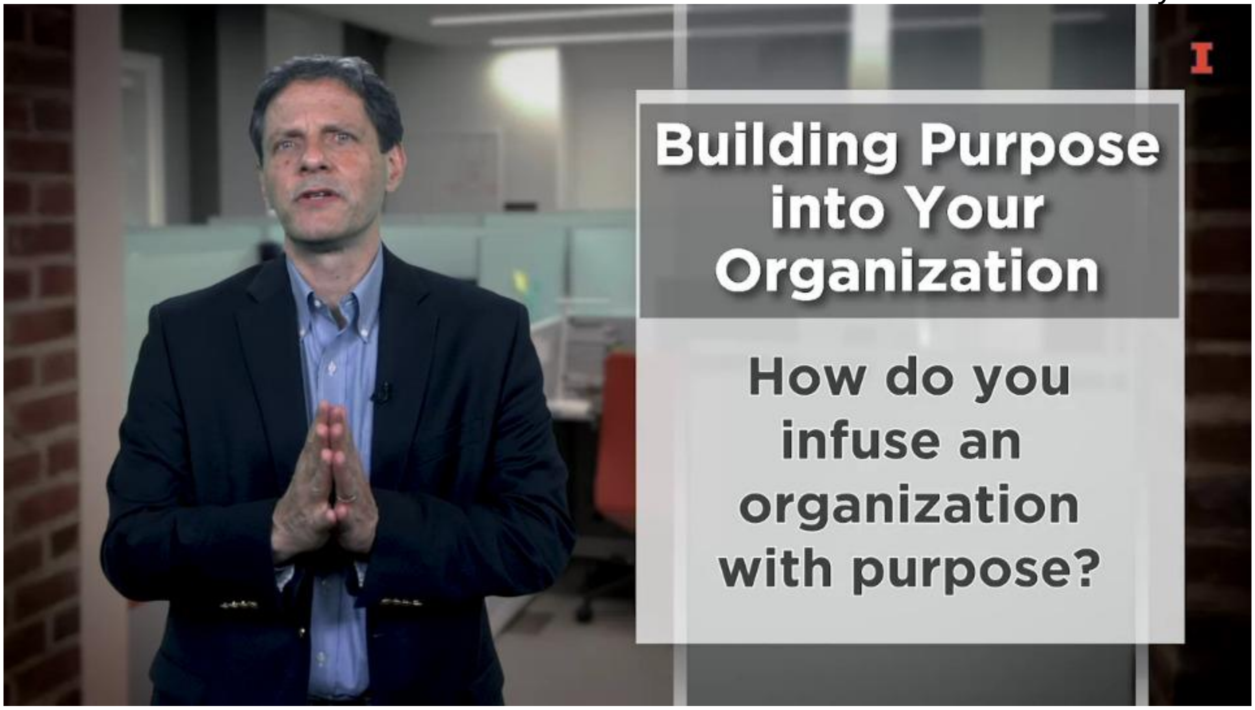
One is that organizations satisfy the needs of customers and clients, they provide value to them, and thus, they make a difference to their customers or clients. Now, making a difference like that might be mundane or taken for granted, but there's often more there than you might think. For instance, think about an electric utility, a very mundane business, but one electric utility built its purpose around the way that it provides reliable electric power to its customers, and focused on how customers relied on that power in their daily lives. So this was how the utility made a difference. This example, by the way, is from an article by Bob Quinn and Anjan Thakor, in Harvard Business Review, that I'll draw in quite a bit as we proceed, and that I highly recommend if you're interested in this topic. So a second underlying source of purpose, is being or becoming something desirable.

So a second underlying source of purpose, is being or becoming something desirable. You see this all the time. You see this when firms say they want to be the best, when they want to beat a competitor, being good at something like innovation or operations. This can be the core of building a purpose. Here's an example, for years, Komatsu, the Japanese equipment maker, their purpose was encapsulated in the simple statement, 'Beat Caterpillar'. That gives you a quick illustration of the motivational power that purpose can bring if your people commit to it, they've got something that matters every day. The idea of being something also appears when the purpose revolves around living a set of values. So we can see that there's many potential ways to build an organization's purpose. You can also start to see connections between the core activities and the organization's strategy. The two bases that I talked about so far, making a difference, and something that the organization does well are probably the most common ones that you see.

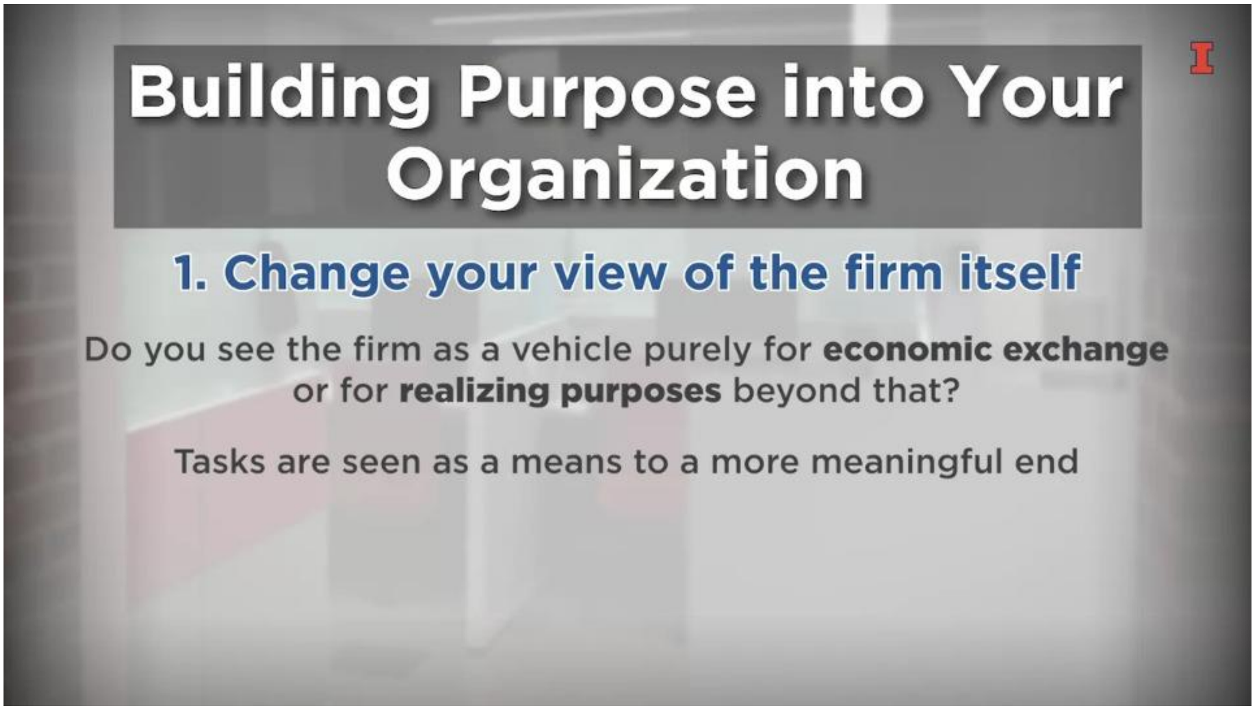
So for the remainder of the video, I actually want to focus on that first one, the idea of making a difference to others. It's an example yes, but I believe it's particularly robust and accessible to organizations. So it's more than just an example that way. Almost every organization has clients, customers, that it provides value to and so makes a difference for. What about your organization? Think about what do you do? Who do you make a difference for? Keep this in mind, as a tangible purpose, as you work through the video. Okay. So we've talked about what purpose is in our context. Now let's move on to why this might be a good idea. You might wonder, this sounds nice, but what are the benefits?



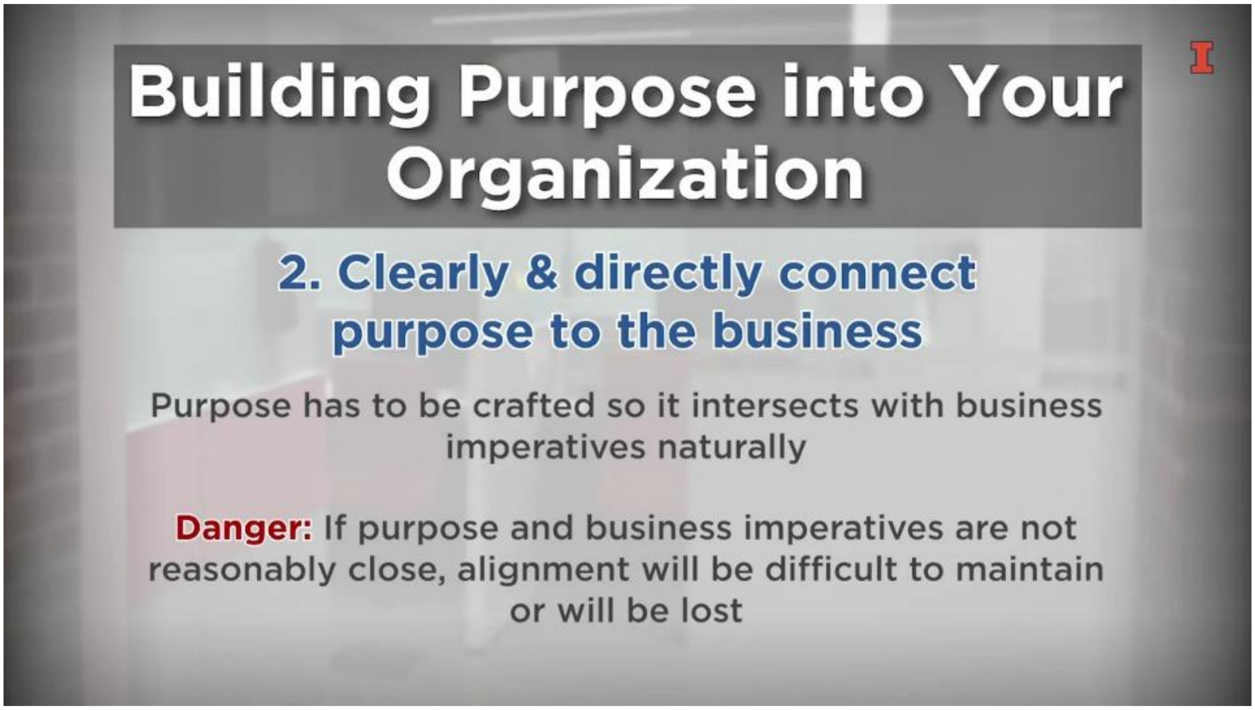
To answer, we'll start with employees, they're the first and main audience here. The headline is that infusing purpose into jobs makes them more motivating. When people see that their job has a purpose beyond themselves through making a difference to others, that makes the job meaningful. People have a need for meaning and purpose. Research on job design from long ago, even in the 1970s, found that when people see their jobs as making a difference, those jobs are more motivating, it leads to more willingness to help other employees, more willingness to offer people's own ideas about how things can be done better. Another thing is more recent is the idea of pro-social motivation. The idea that we're fundamentally motivated to help others. It's a big thing in psychology these days, and you can see the link to making a difference to others. Now the efforts that companies make can be visible and notable. They can show up on a large scale. Companies that work on infusing purpose start to show up on lists of best places to work and the like. But you might think, well, what about shareholders? Is doing this a distraction in terms of profits? Now here there's some research and what it does is it looks at profitability and what happens when clarity about purpose is connected to profitability. The research suggests this can help on the financial side and certainly that it doesn't hurt. So infusing purpose sounds like a win-win situation. It makes jobs better and companies better and that's why there's a lot of interest in it at this point, I think. All right then.



So now it's time for us to talk about the action question. In this second part of the video, we're going to talk about how do you infuse an organization with purpose. I'll discuss four major ideas for you to keep in mind. In doing this, I'm drawing on the Quinn and Thakor, Harvard Business Review article, but also work on mission statements.

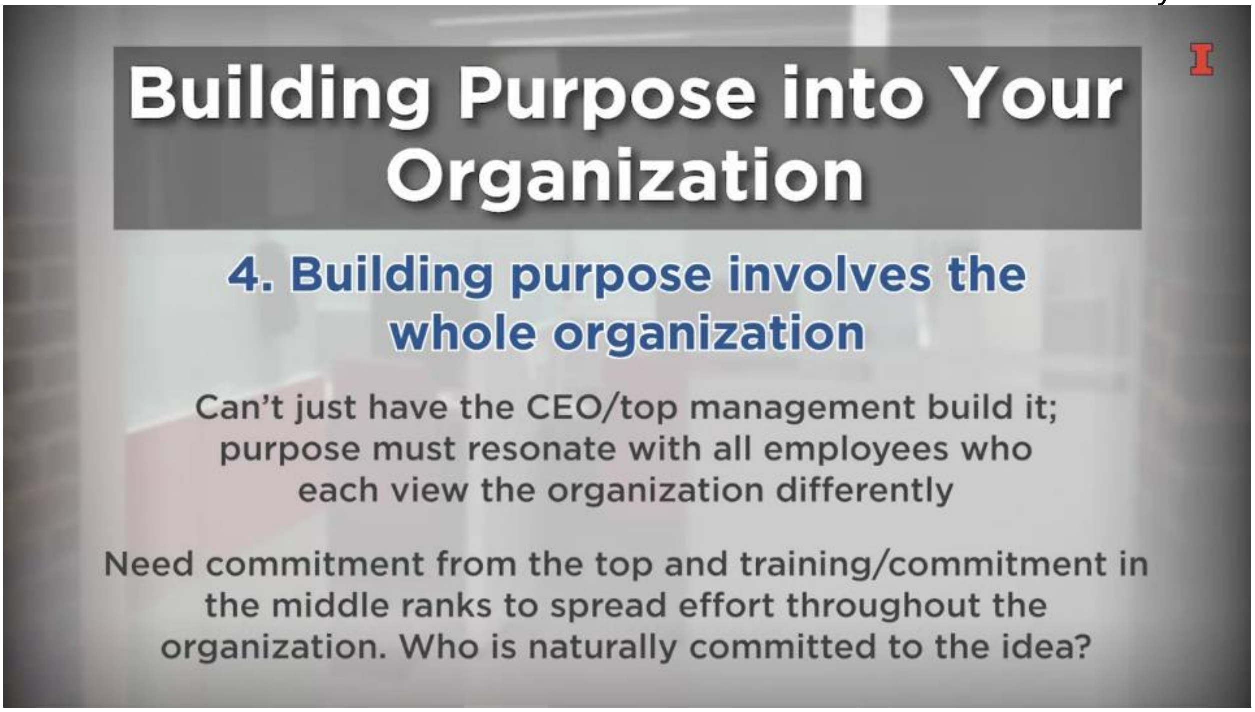


So the first of these four big ideas is you need to change your view of the firm yourself. What do I mean here? Well, the question is, do you see the firm as a vehicle purely for economic exchange back and forth, or for realizing purposes beyond that? A purpose of making a difference in society. To see this, let's take Walmart, Walmart's mission statement, "Saving People Money So They Can Live Better." Now, Walmart's obviously a firm that we know is very focused on costs and economics, but that makes this a great example because look at that second part, "So They Can Live Better", that references a purpose that goes beyond a firm. Walmart makes a difference for its people. So it's a very big deal to go for this kind of purpose, but it doesn't mean you aren't customer-focused or focused on doing things efficiently. The idea is that tasks are seen more as a means to a meaningful end rather than as ends in themselves.

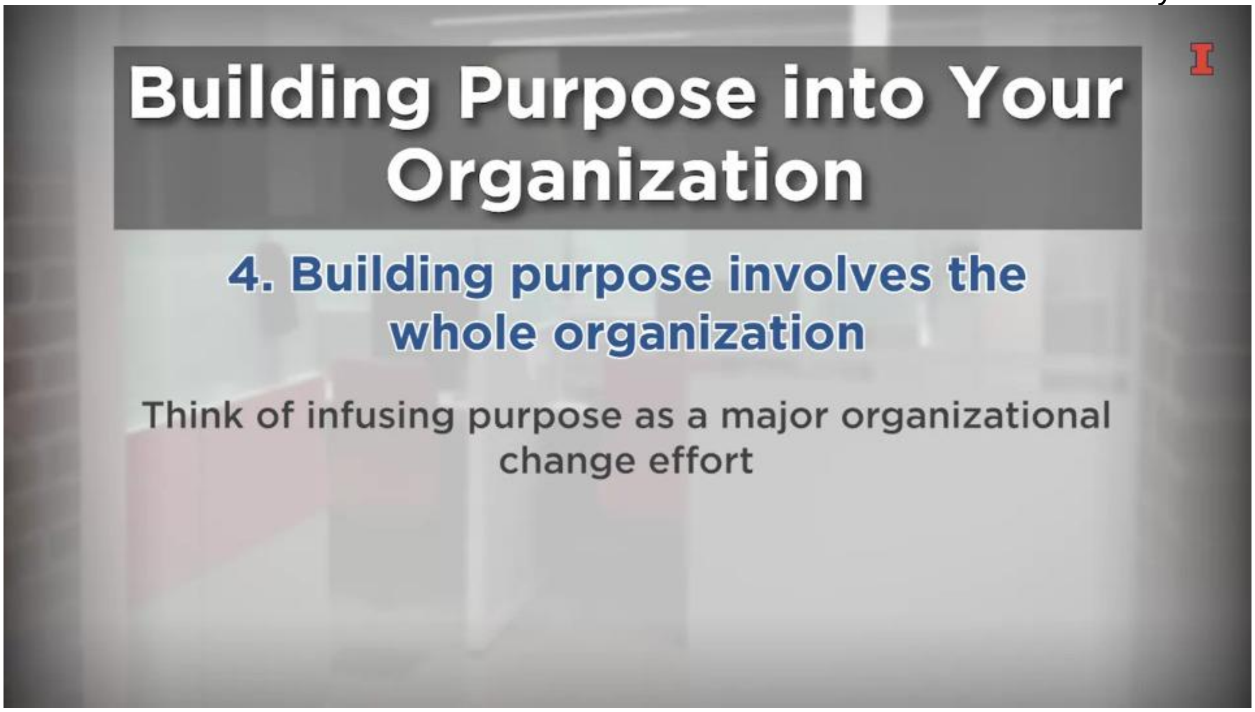


So the second idea, the second of the four, is about how to infuse purpose through clear and direct connection between the purpose and the business. It's related to the first point, but it's also about how you craft that purpose, the mission statement, whatever it is. Purpose has to be crafted so that it intersects with business imperatives naturally. Purpose has to build on the idea of delivering value in exceptional ways. The reason is that there's a danger. If purpose in business imperatives are not reasonably close, well, alignment between the two can be difficult to maintain or be lost. Think of this mission statement, from a very well-known firm, "We work to help people and businesses throughout the world realize their full potential. This is our mission." What you see here is actually quite a noble purpose. It's all about making a difference. But at the same time, it doesn't lead you directly to a particular strategy the way the Walmart one did. It doesn't mean it won't work, it just means it's going to take more work to align purpose and strategy, than that Walmart example that I went over before.

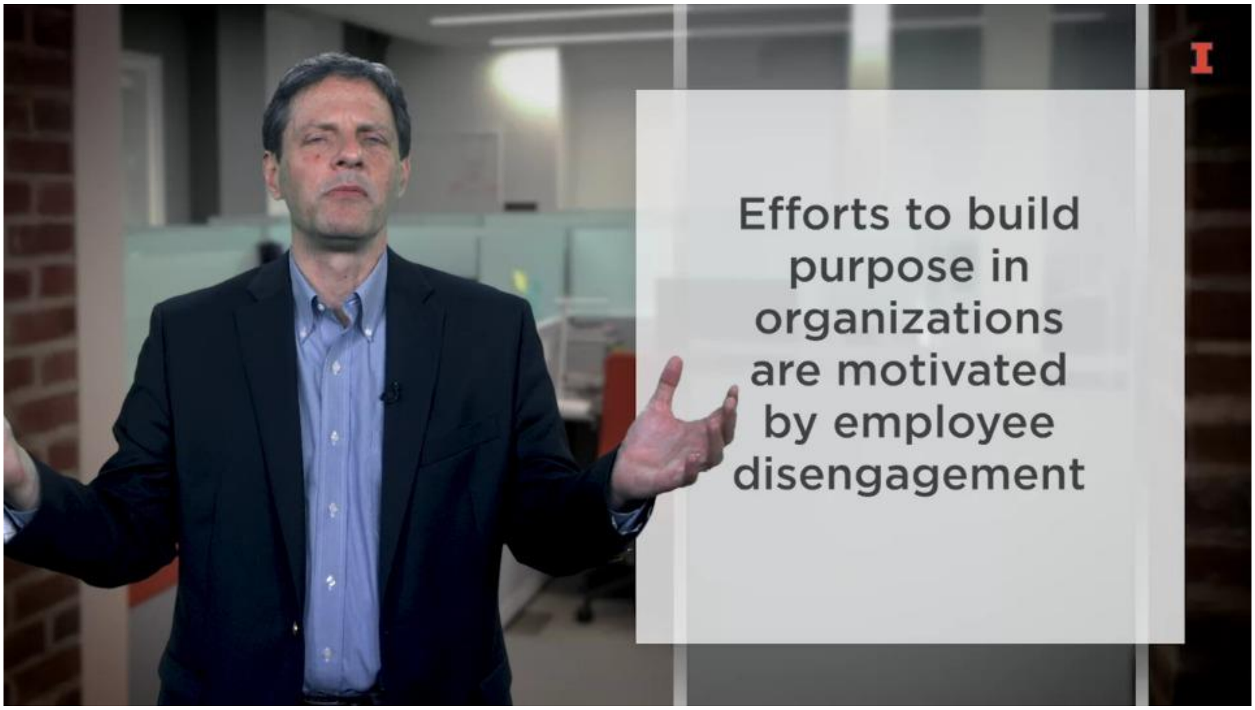
So the third point, this is that achieving purpose depends on commitment and authenticity, particularly from your senior managers. Commitment from the CEO and other senior executives is essential, because for most companies, talking about purpose is a big change. The idea that an organization is driven by purpose, that culture is infused by purpose, this takes time and work, like any other major change project. So without commitment, this won't happen and purpose will just become a slogan. Then there's authenticity. This is essential because you as the manager are not just saying work has meaning, you're asking for more from your people. If it ends up being seen as just a clever scheme, where top management is doing it as a way to raise profits in the end, it will breed cynicism and will fail. Authenticity, it means full buy-in by managers, most notably through connecting purpose with decisions, rather than just mouthing words about purpose. For instance, I've watched the CEO of a large healthcare organization talk about mission being about making patients lives better, and about the key question to asking decisions, is does it help the patient? This is the kind of connection that leads people to go ahead and say, well, this is an authentic effort, it has impact, and it's essential for building purpose into the organization.



So the last idea is that building purpose involves the whole organization. It happens person by person. You see this first when you construct the purpose or discover it. The idea is that it's already there but articulating it requires dedicated work. The key is you can't just have the CEO and top management build it, you need people from all around the organization be involved. That way, you're going to end up with a purpose that will resonate with employees who have very different relationships with the firm and with this clients or customers, than top managers do. You also see the whole organization in the leadership required to build a purpose-driven organization. You need commitment at the top, which I've spoken about, but you also need training and commitment in the middle ranks, to spread the effort through the organization, as well as efforts to find people throughout the organization in different parts who are naturally committed to the idea, they can serve as leaders as well. You need communication to every individual to show how it works for them.

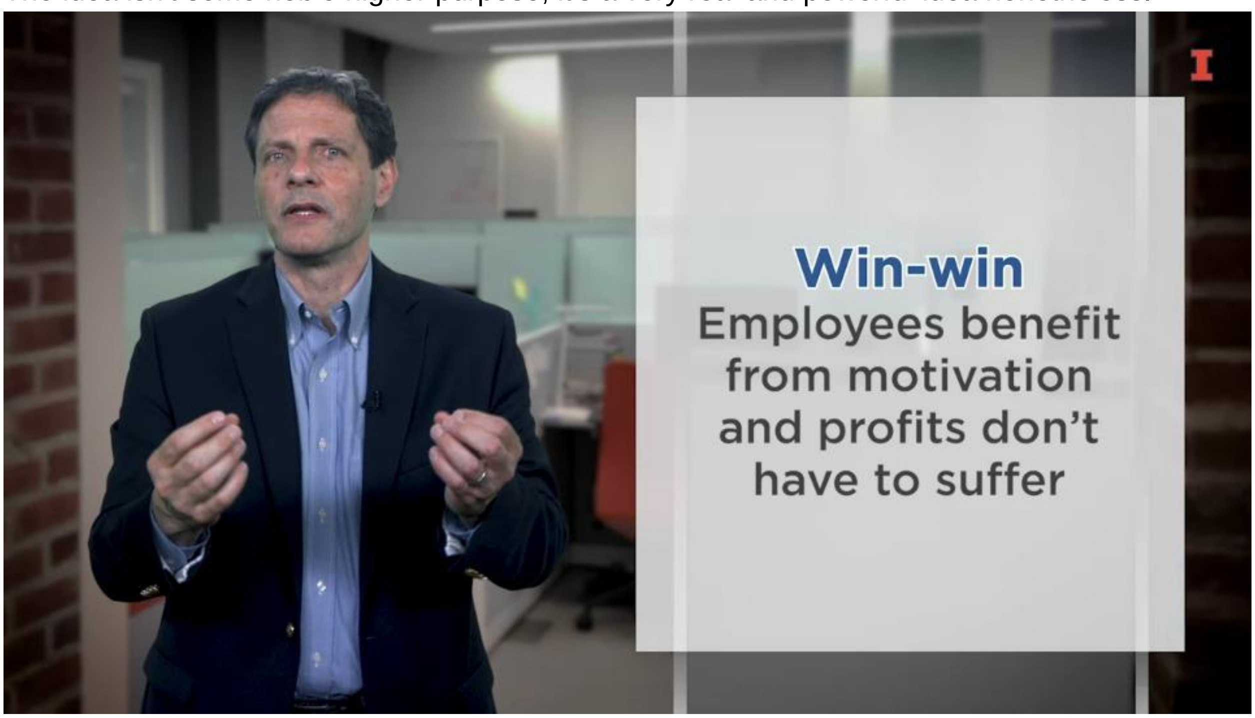


One analogy here is just to simply think about infusing purpose as a major organizational change effort. There's a strong parallel between the two and the effort required. So when we think, "Who does this?" The answer is, it's more than top leadership, more than the managers, it's the whole organization. All right then. We've covered a lot and let's talk about what you might want to take away from this video.

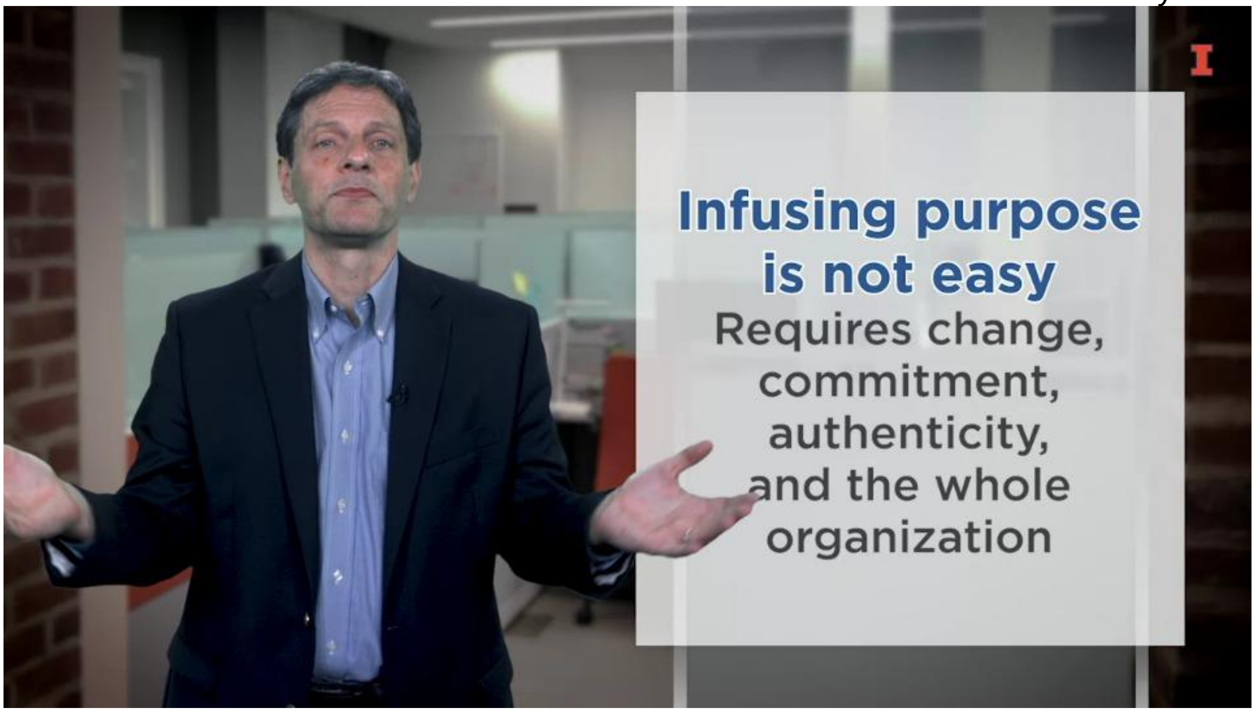


First, the idea is that efforts to build purpose in organizations are motivated by employee disengagement. That's the problem that we're trying to solve.

Second, know what we mean by purpose. Here we focused on making a difference for others. The idea isn't some noble higher purpose, it's a very real and powerful idea nonetheless.



Third, know that there's good evidence that it can be a win-win. That employees can benefit from more motivation in the job, but profits don't have to suffer.



Finally, know that infusing purpose is not easy to do, it's not for every organization, it requires big changes in how we think about the firm, it requires management, commitment, and authenticity, and it involves people all through the organization.

Lesson 1-4: Mission Statements

Lesson 1-4.1: Mission Statements

Today, we're considering mission statements; what they are, what functions they serve, and what it takes for them to be impactful. Mission statements are ubiquitous, surveys indicate that almost all large firms have constructed one. This suggests people believe that they work, they do something good. But at the same time, sometimes they're characterized as a plaque on the wall that doesn't reflect reality of the firm. So there's real value in digging a bit deeper here and what we're going to do is, we're going to go at this in three steps.

First, we'll talk about what mission statements are, this is a little more complicated than it sounds as you'll see. Second, we'll look at what functions they are intended to serve. Finally, we'll talk about that most critical question, how to make them impactful?

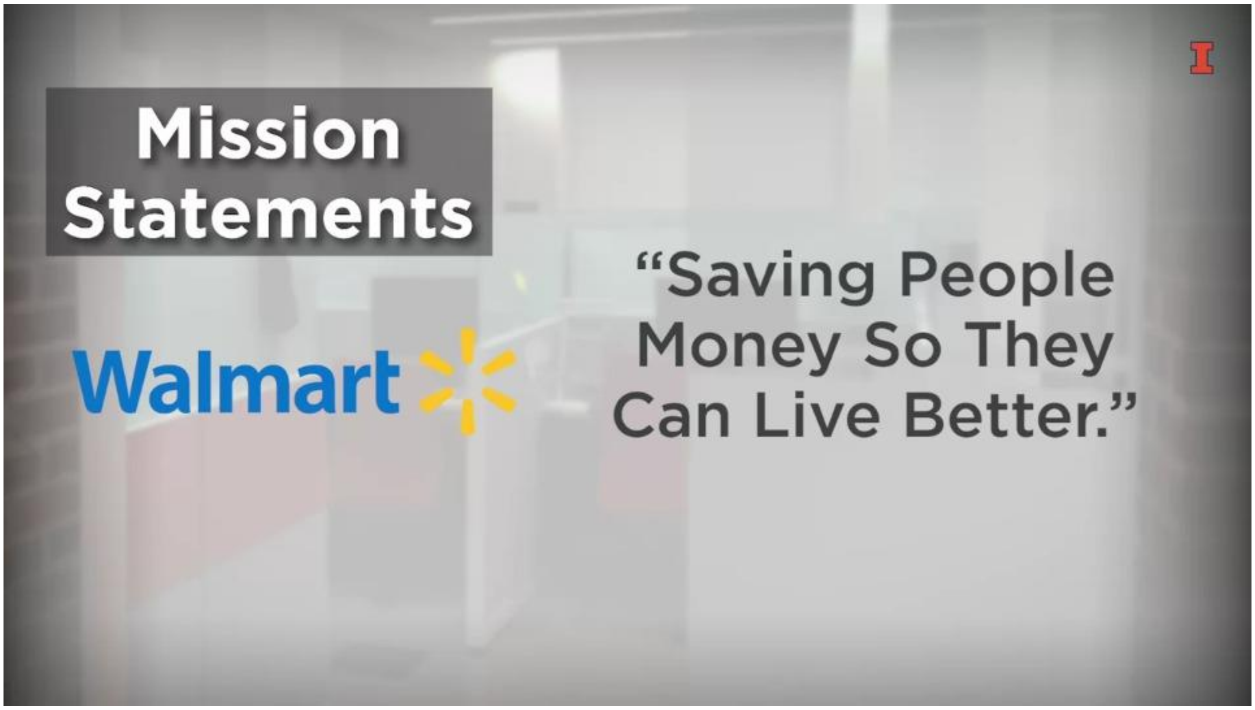
So to that first question, what is a mission statement? Well, here's one definition adopted from a popular textbook and I'll just let you read it. But one thing to know is that there's a constellation of components here, the ones that I've underlined, there's multiple parts, some of which deal with the what the organization does and some about the why, the purpose. That's important as we'll see more soon. So if you've got that definition in mind a little bit, let's just look at some mission statements, all of these are from Fortune 500 firms.

So first, take a look at Advance Auto Parts here, read through it and what do you see here? Well, I started here because you see the products, you see the customers, you can infer what the purpose is here and there you go.

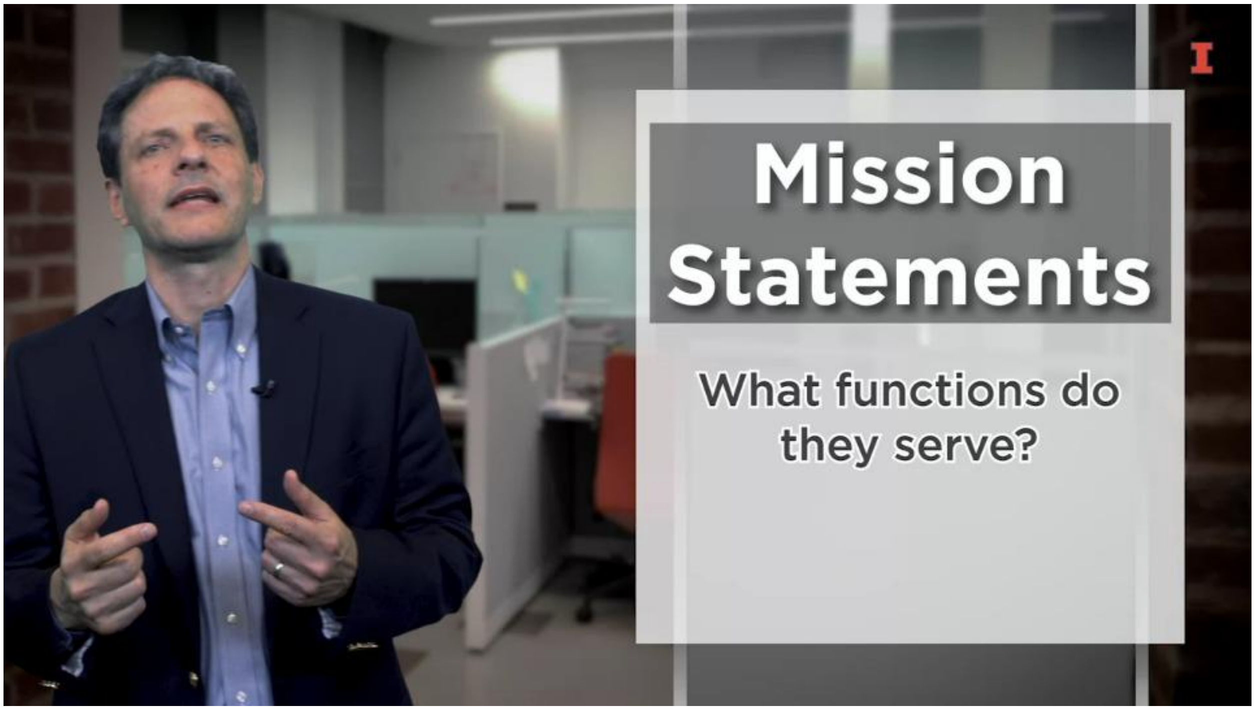
Now take a look at another, American Standard, being the best, that's looks quite different, the focus here is distinguishing from others. Doesn't say how, but it makes that commitment.

Here's one company, most of you will have heard of, Facebook, look at what they say. Now this one's more abstract, it's about what we're going to make the world more open and connected. So it's a little less clear concretely what they do, but it does give you an idea what the company is intended to do, it relates it clearly to its several services, you can say whether an app fits this definition or not.

Next one is from Microsoft and this one's a little different. The purpose is very clear here, if you look through it, who is clear? It's everybody they're aiming at. There's a sense of how they work internally as well, some values are starting to show up.



Finally, Walmart, very short, the purpose is here, how they do it is here, there you go.



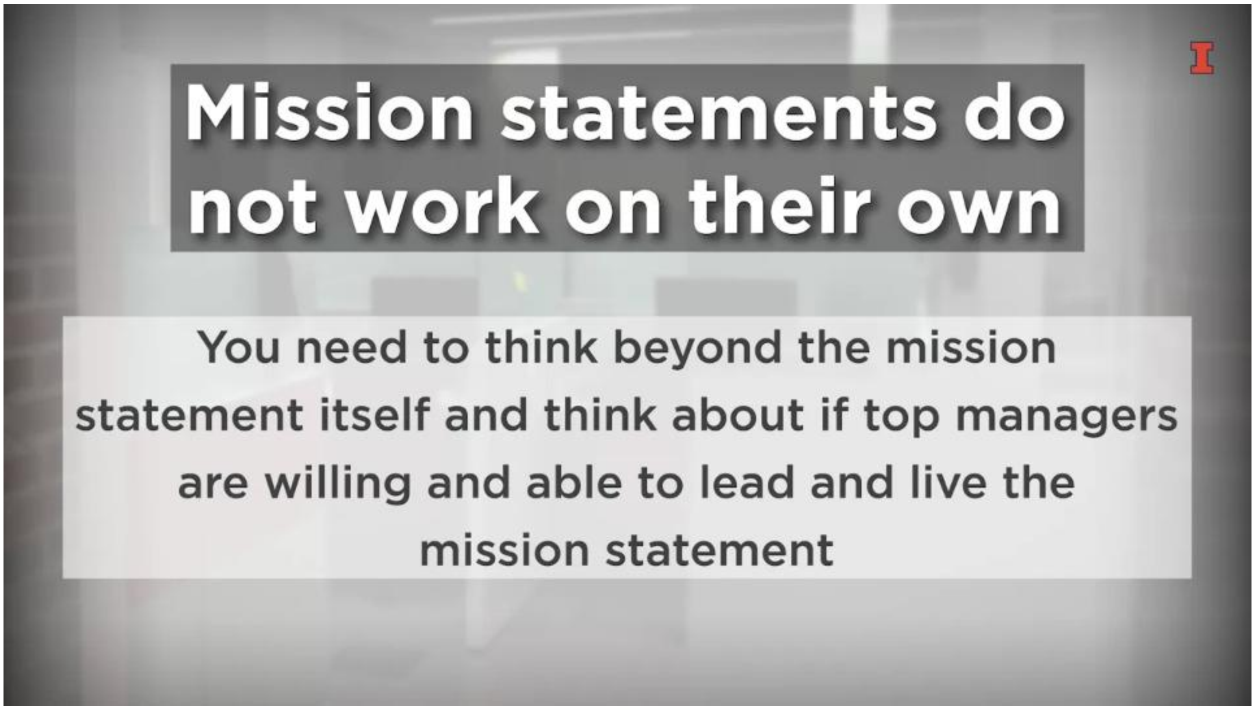
So stepping back, what do you think having looked at five of these? They look very different for one thing, some includes product, some include customers, some are concrete, some are abstract, some are short, some are long. So the important thing to remember here is that those differences aren't necessarily good or bad. The differences arise in part becomes firms want the mission statement to do different things and that leads to the second question that I started the video with. That second question, what is the mission statement supposed to do? How is it supposed to make a difference? Who is the audience and how should it affect them? That's what we look at next. Now, here's what's interesting, there's at least three main things companies have wanted the mission statement to do.

The first one is about strategy and planning, the idea is that the mission statement can be an integrative force and strategy and planning to get everybody on the same page, to get them aligned regarding key strategic issues such as how are we going to compete and what markets will focus on. This is where mission statements started in the 1980s and 1990s, responding to concerns that conglomerate firms had no coherent strategy. You can see this function in different ways in Advance Auto Parts or the Facebook mission statements. Now over time, things branched off, one branch grew around values and ethics. The idea was to use mission statements to strengthen employee's sense of values and ethics, how to act at the firm? What are the right things to do and the wrong ones? This branch separated though into value statements more than mission statements. So we're not going to focus more on it here. But another branch developed and this is one that I think is an increasingly strong one, it's about purpose. The idea is the mission statement helps define the firm's broader intent or purpose and so it engages employees rather than aligns them. Now, this branch came in response to recent trends, where employees are increasingly disengaged at work, yet they seek engagement. So the mission statements you see here might be more aspirational, might point towards making a difference. So for example, you can see this very clearly in the Microsoft value statement, about achieving potential and less do you think that is only the technology companies do that, think about Walmart's, about helping people live better.

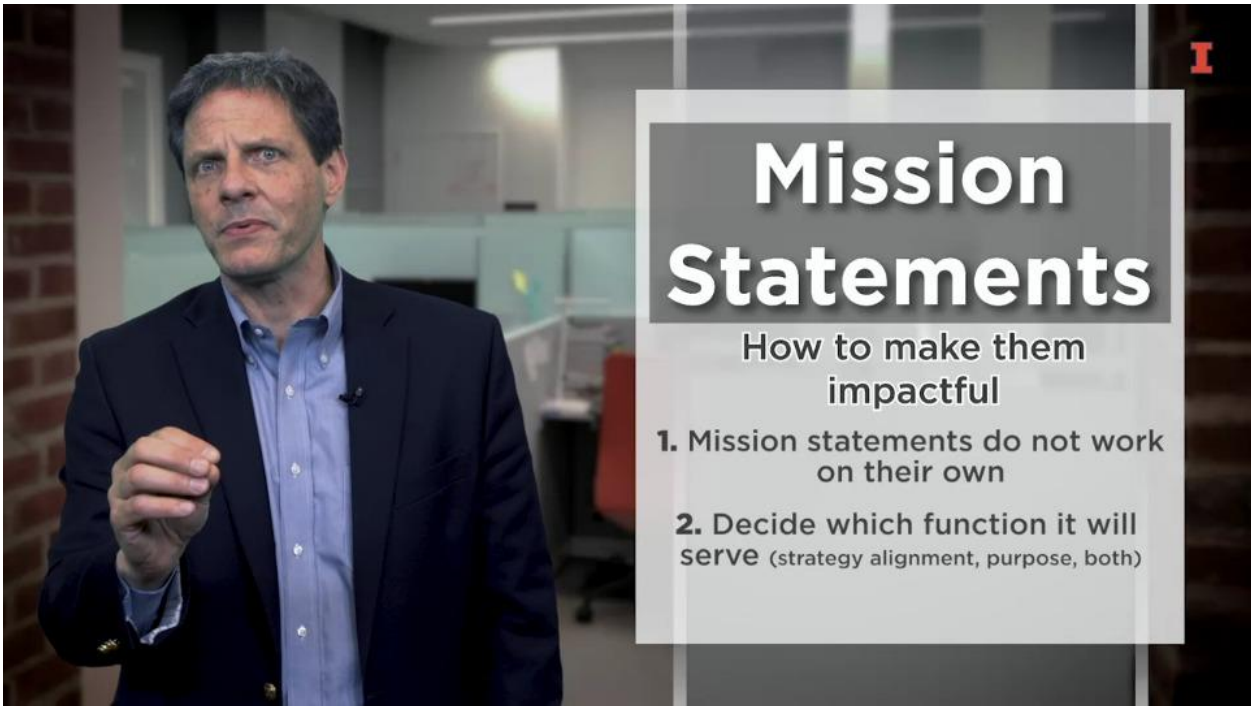
So the branches I have described aren't necessarily mutually exclusive, but they are distinct. So when you think about this question of what the mission statement is supposed to do, keep them in mind.

Now we can move to the last question, what has to happen for mission statements to be impactful? Which ones work and which ones don't? Now, this is not a simple question, I really got three things for you to think about. The first and most important thing might surprise you, that is, you want to think first not about what the mission statement says, but about the idea that mission statements do not work on their own.

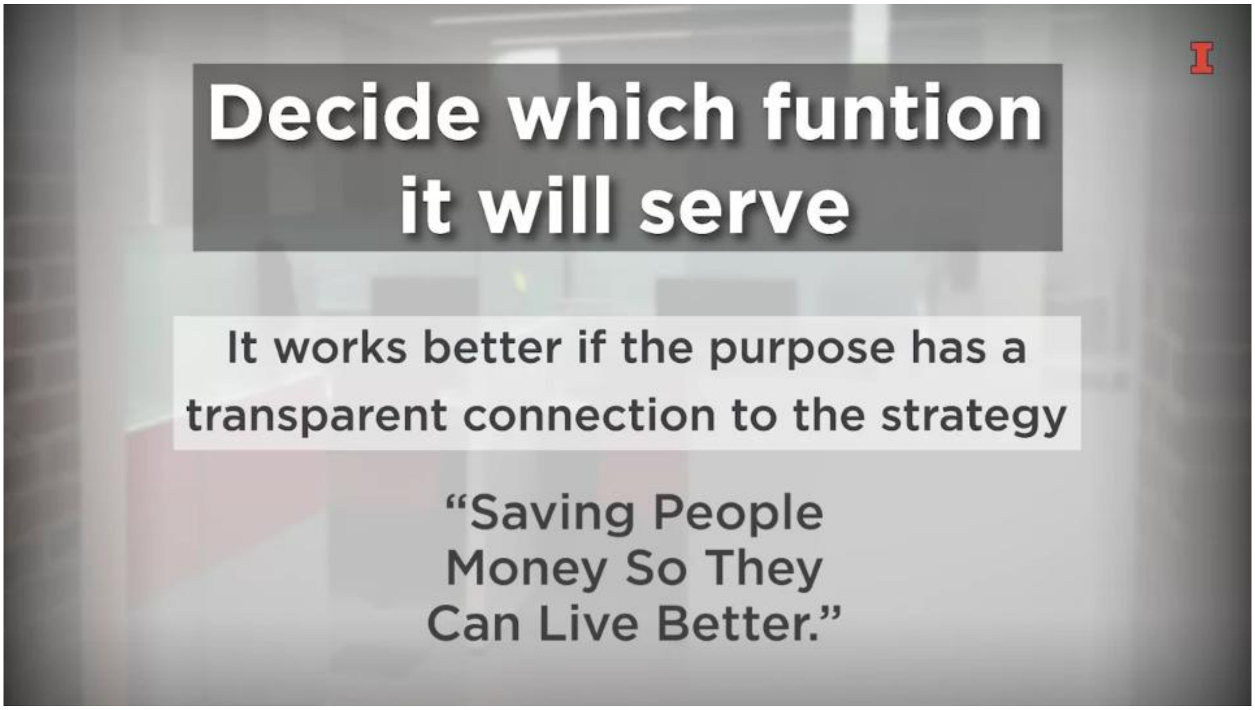
There is research suggesting that mission statements can improve performance, sure. But there's also research suggesting that over half the time, mission statements don't reflect the reality of what happens in the firm and also that any performance benefits you might see depend on top management commitment.



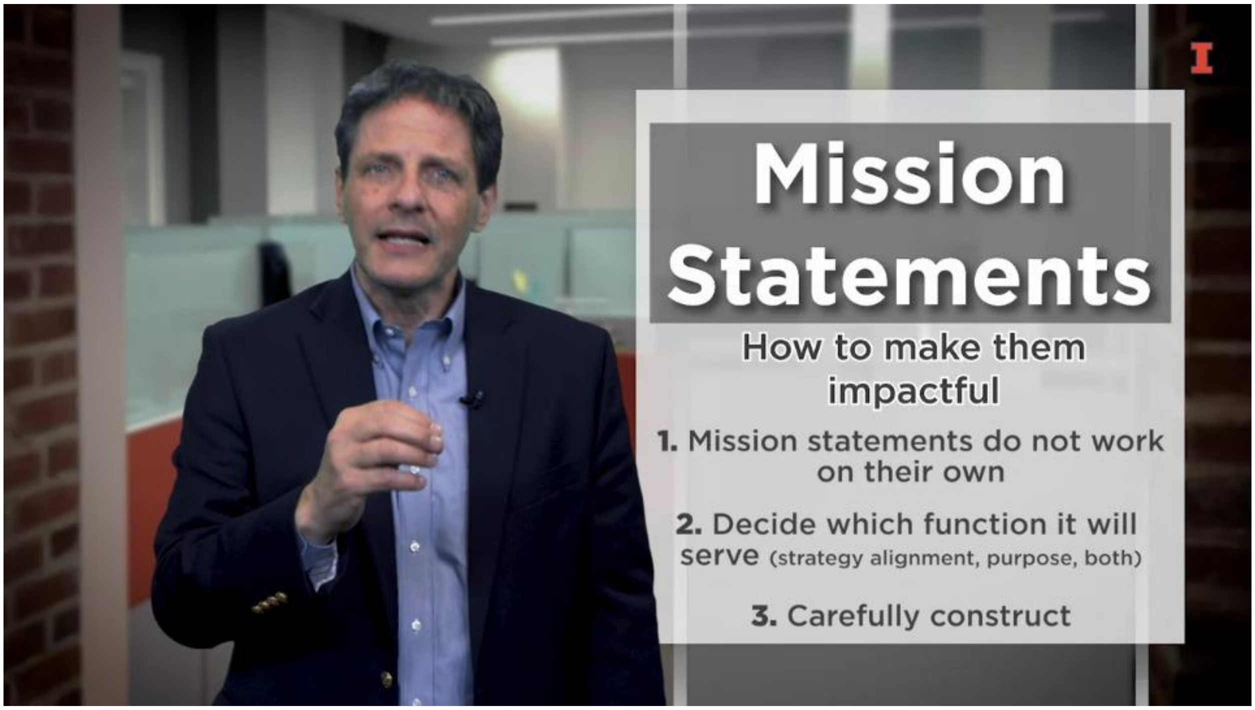
So the first key idea is, you need to think beyond the mission statement itself and think about if top leaders are willing and able to lead and live the mission statement.



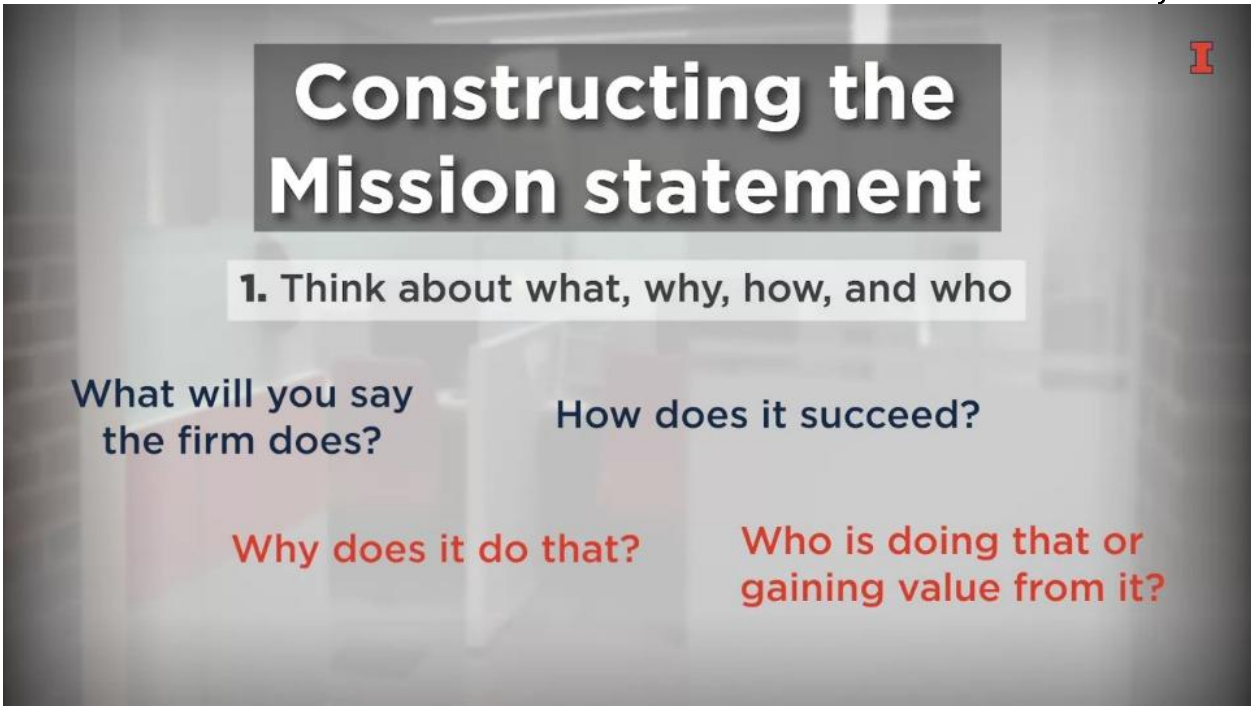
The second thing to decide is, which function the mission statement is going to serve? What branch of that tree? Is it strategic alignment? Is it purpose? Is it both? The mission statement is going to look different and connect to different audiences depending on this. Strategic alignment means you're focusing on manager's, purpose implies you're thinking about everyone.



Now, one related point about purpose, it works better if the purpose has a transparent connection to strategy, think about Walmart's mission statement, about helping people live better. I've seen executives lean on that idea of making a difference to give a very inspiring talk based on that statement. But then it gains power because they connect it directly to the firm strategy.

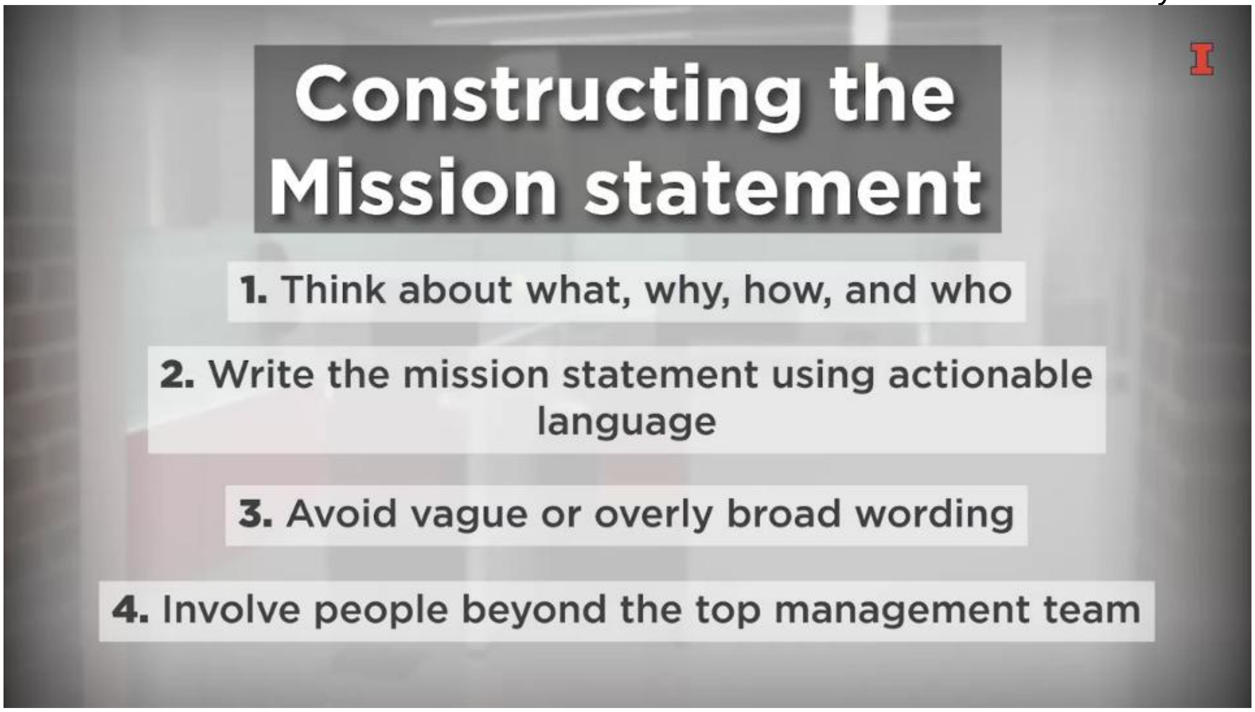


The last thing to say about how to make mission statements impactful, is about how you might actually construct the mission statement, now this isn't a how-to or more about broader issues to think about. But let's talk about a couple of things.



First, when you're writing a statement, think about what, why, how, and who, what will you say the firm's does? Why does it do that? How does it succeed? Who is doing that or gaining value from it? These simple questions give you some guideposts and if you think about the mission statement Advance Auto has, it's a good example of one that checks the box is pretty well here.

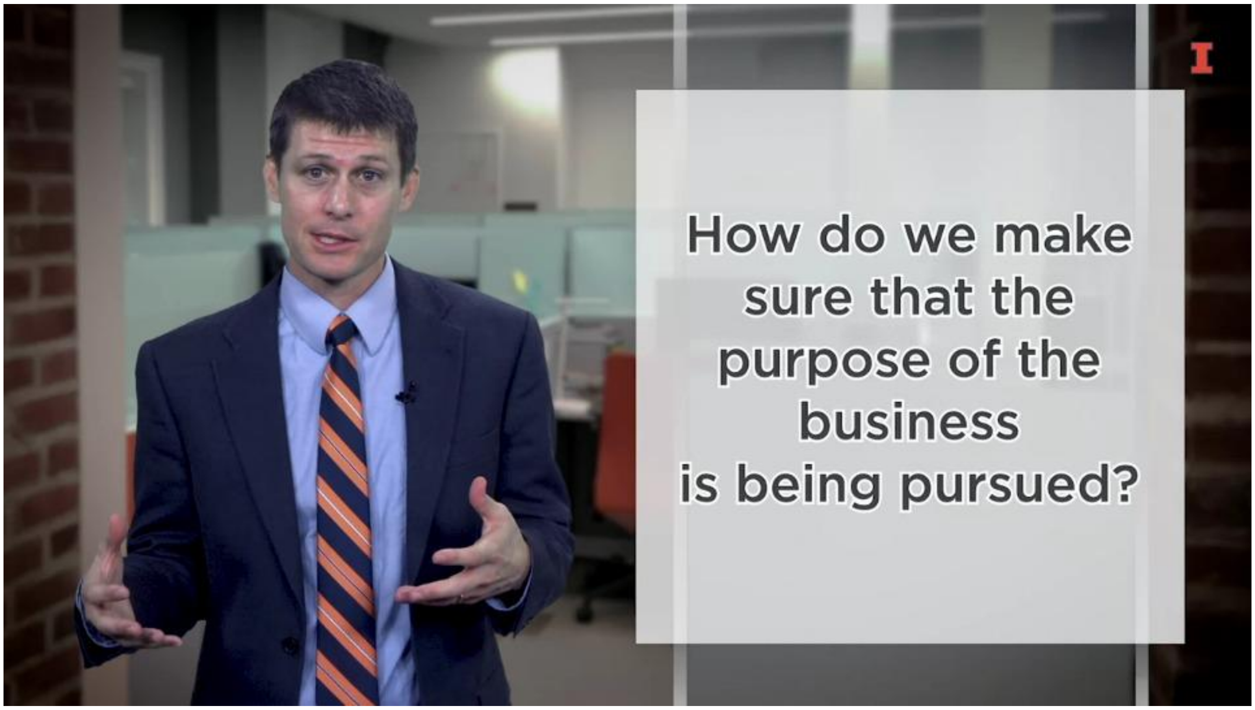
If you can go through your mission statement and it provides a clear answer to those questions, either explicitly or implicitly, you're probably going in the right direction and if one or more is unclear, that might be a concern.



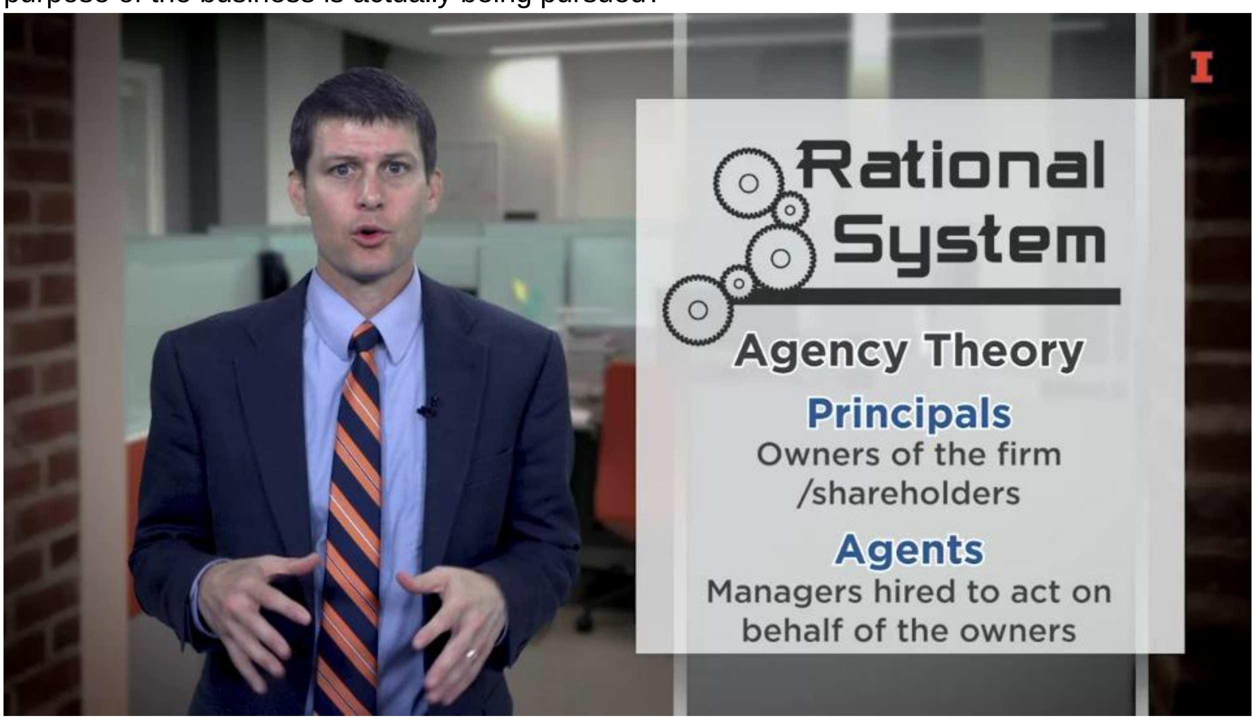
Second thing, work to write the mission statement using actionable language. Make it point in a clear direction, so that employees or managers can easily see the connection or not, between their actions and decisions and the mission statement. Now relatedly, avoid vague or overly broad wording, the tension here is that the mission statement should cover everyone. So there's pressure not to be specific and firms seem to fall in this pit fall often, a way to keep balances is to always keep in mind how the mission statement be used. Remember, it's aligning or it's engaging people rather than focusing on it as an object in itself. Finally, you want to involve people beyond the top management team. People at different levels look at their jobs in the company differently. So this will really help build a mission statement they can connect throughout the organization. All right then, so returning to our initial quest, I hope you have a better sense of what mission statements actually look like, the range of functions mission statements can serve, and a sense of what's needed for mission statements to have an impact.

Lesson 1-5: Rational System View of Governance

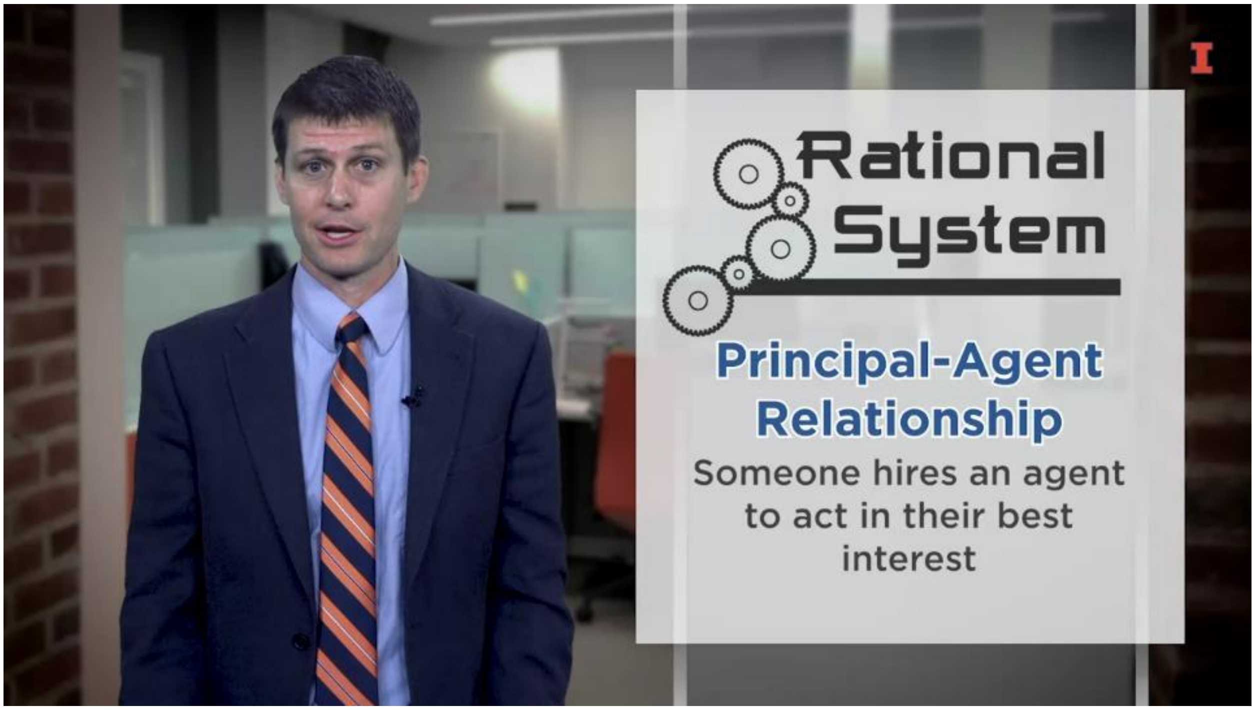
[Lesson 1-5.1: Rational System View of Governance]



If the first part of governance is about determining purpose, the second part of governance is what we call Control. So we're dealing with the question of how do we make sure that the purpose of the business is actually being pursued?



Now traditionally, many of the theories about governance and control in organizations, have used more of a rational system lens. One of the most influential theories in this vein is what is known as Agency Theory. Now in most large corporations, agency theory says that we have two important groups. First, we have the owners of the firm or the shareholders, we call them Principals.Then we have managers who are hired to act on behalf of the owners, we call them Agents. So principals and agents, they make up what is called a Principal-Agent Relationship.



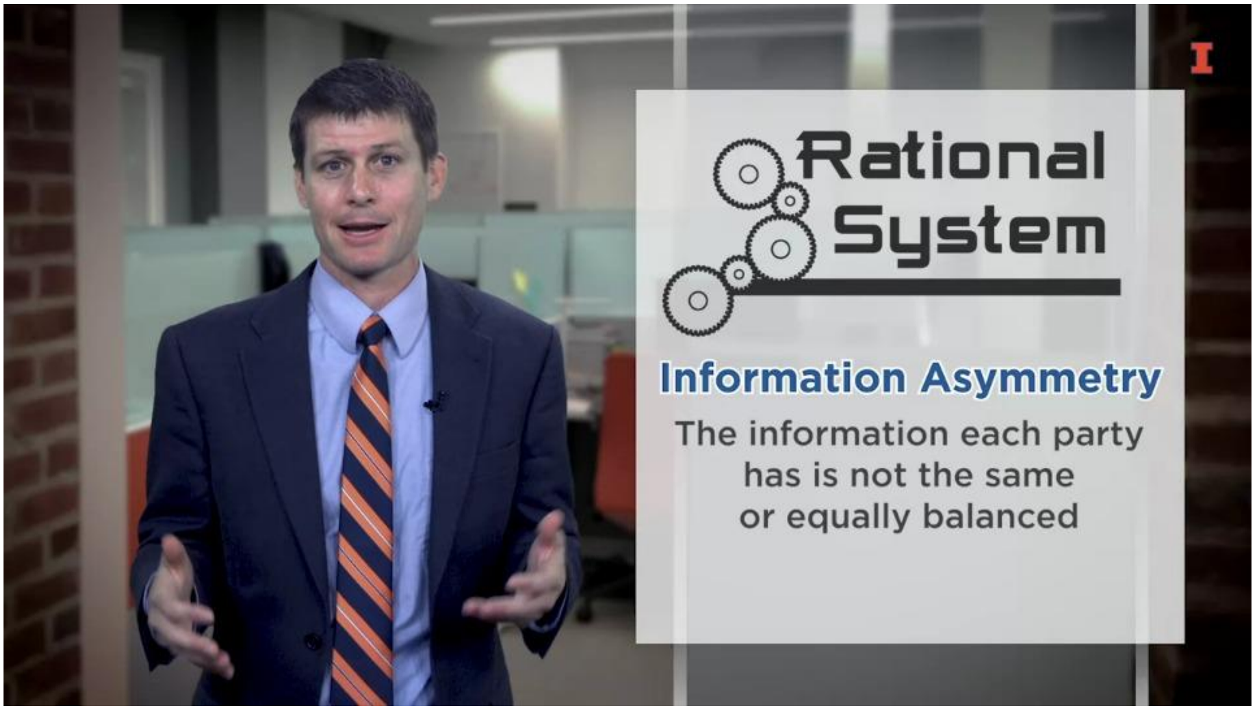
Now principal-agent relationships are just situations where somebody hire somebody else. So a principal hires an agent to act in their best interest. We see these kinds of relationships in lots of different situations. So for example, people sometimes hire financial planners or attorneys or a real estate agent. They do this all the time, they're hiring someone to look after their best interests. In some cases, people like professional athletes or movie stars, they hire agents to manage their affairs. So in the case of a sports agent, a professional athlete hires the agent to act in their best interests, whether that is negotiating a new contract, seeking endorsement deals, or managing their finances. But that same athlete is also going to want to make sure that the agent is working hard and is doing what's best for the athlete and not just what's best for the agent. So in large publicly traded corporations, we have a classic instance of this same kind of relationship, a principal agent relationship.

Here shareholders are the principal, managers are the agents.

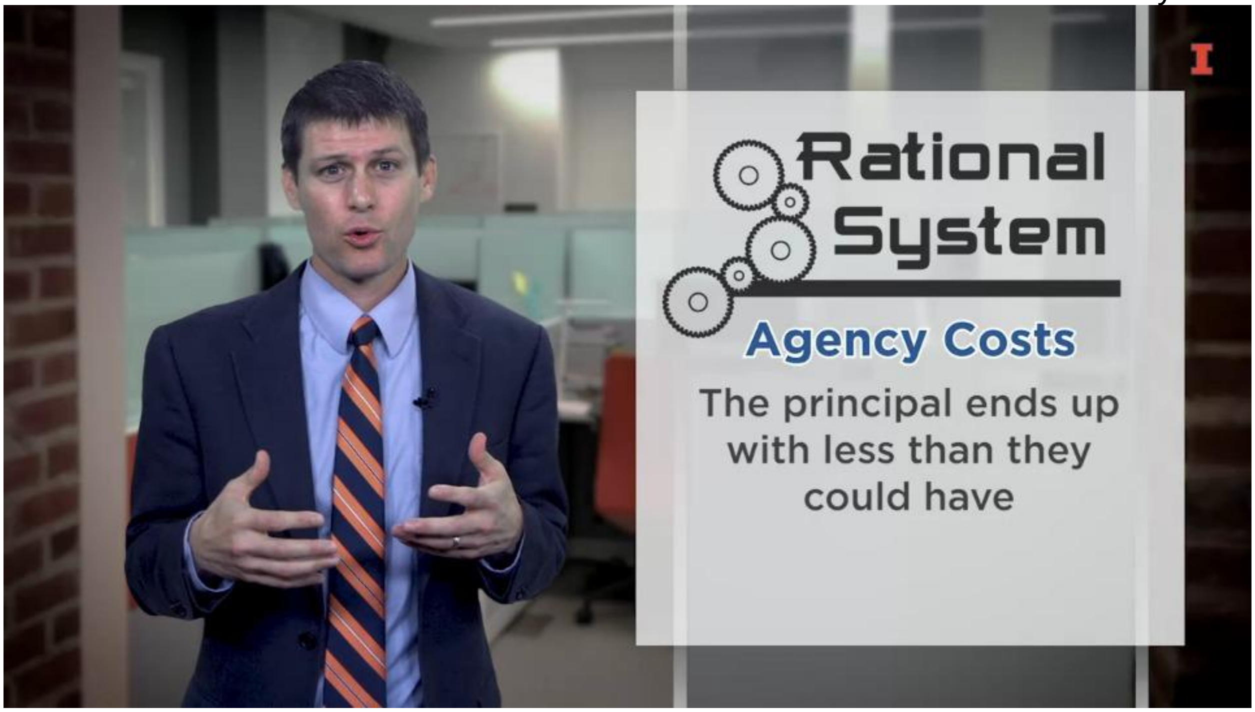
At the same time, we have a board of directors that is hired by the shareholders to represent them. So in theory, the board can be thought of as doing what the principal would do. This adds another layer of complexity to the principal-agent relationship.

Now the board holds the highest decision-making authority at the firm. They're the group that hires, evaluates, compensates, and sometimes fires management. They ratify big strategic proposals and are ultimately responsible for the health of the firm. Now, just as the professional athlete might be concerned about whether their agent is working on their behalf, shareholders have the same worry about managers.

Shareholders may worry that managers are not working as hard as they can, or that they're shirking their responsibilities. Or it could be that the managers are working really hard, but they're just not doing the things that will maximize returns for the shareholders. But it's hard for outsiders to know exactly what managers are doing. That's what we'll call Information Asymmetry.



The information each party has is not the same, or if it's not equally balanced, so it's not symmetrical. Managers want to keep their jobs, and so they may be more cautious in their decision-making than shareholders would prefer. If I'm a shareholder and I can diversify my portfolio of investments, I may want management to engage in strategies with a higher possible return. But it's going to be really hard for a shareholder to know whether the manager is being overly cautious or just prudent. Another key difference is that managers and shareholders sometimes have different time horizons for which they are seeking returns. So you could have a short term investor that just wants to see a return now, while a manager wants to make decisions with a longer-term view of the firm. It could have the opposite where an investor is looking for long-term gains, while a manager wants to increase short-term profits to get that quarterly bonus. All of these factors contribute to situations where agents may not completely act in the interests of the principal. According to agency theory, this creates what are called agency costs.



Because now the principal ends up with less than they could have. So how do firms overcome this agency problem?

Direct monitoring, incentives and changes in control. Let's go through each of these. So the first way to overcome this agency problem is through direct monitoring of the agent. So that means somebody directly evaluates what the agent is doing to verify that their actions are aligned with the interests of the principal. This happens largely through the Board of Directors. So in publicly traded firms, boards typically have directors who don't work for the firm or have other conflicts of interests. So they are thought to be more objective in this monitoring role. That's what we call board independence. In addition to the board, large investors can provide monitoring in management. So while I may not own enough shares of a company where it makes sense for me to closely monitor managerial behavior. A large institutional investor that owns a five percent stake in a company, they aren't likely to monitor what management is doing. So large investors can sometimes apply pressure. They put pressure on firms to make changes if managers are not acting in their interests. Other organizations can provide monitoring as well, including rating agencies and even the media.

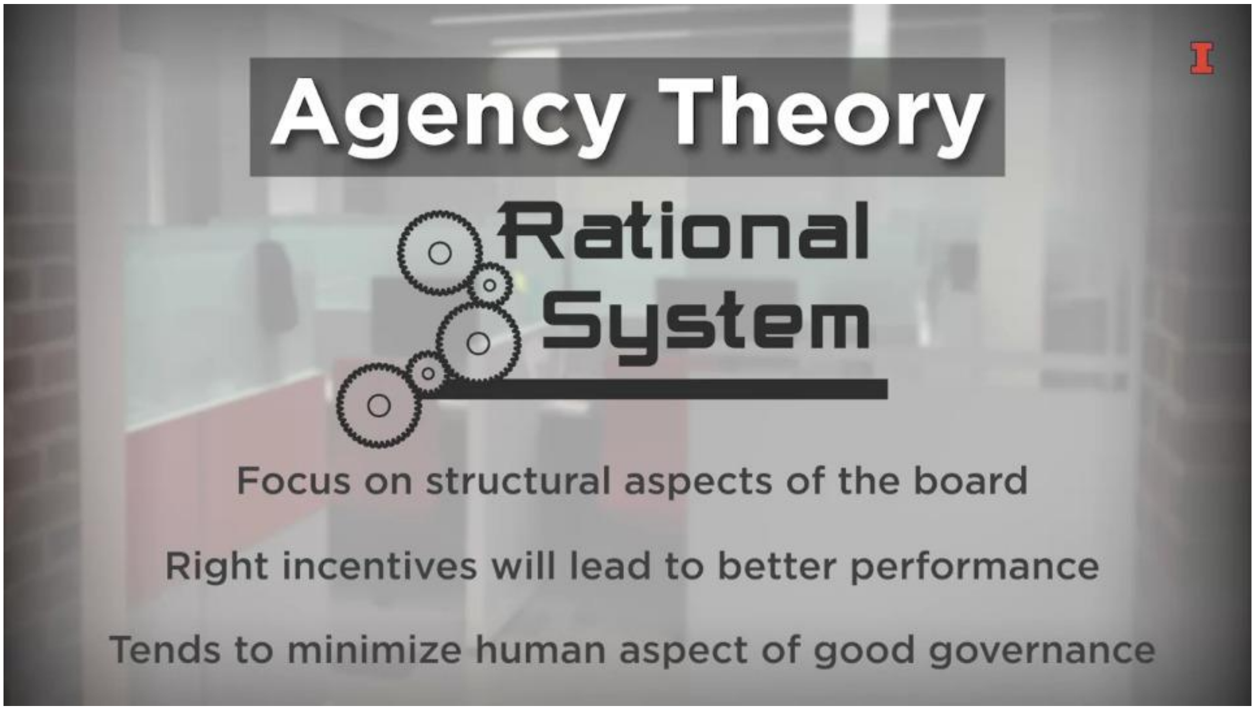
So a second way to overcome this agency problem is through incentives. Executive compensation can be used as a way to align the incentives of managers and shareholders. So top managers are often paid with stock, stock options or they have compensation that's tied to hitting certain goals.

A third factor that can help overcome this agency problem is the fact that poorly run companies can get taken over by outsiders. That's what's called the market for corporate control. So the idea is that managers are more likely to work hard and work in the interests of shareholders so that they can keep their jobs.

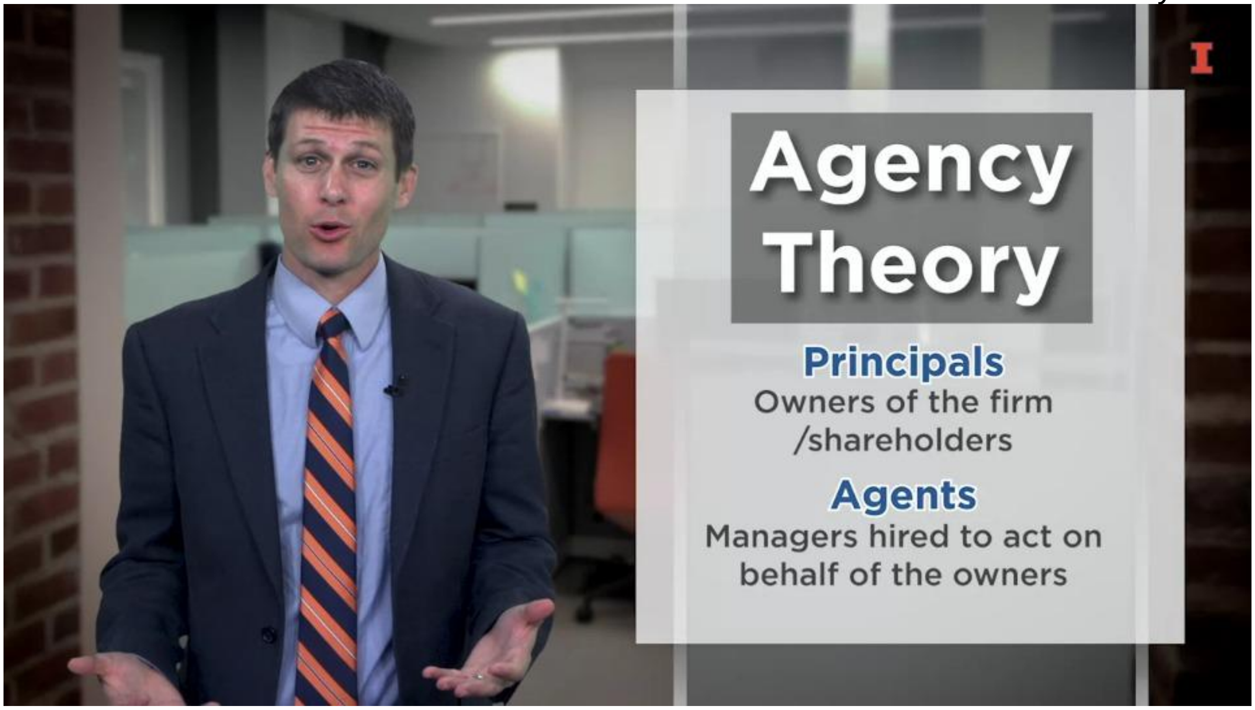
This is not an exhaustive list of control mechanisms. But these are three categories that do represent some of the most common, most often studied ways that firms try to get managers to act in the interest of shareholders. One other thing to think about. These same control mechanisms can be useful at other levels of the organization. So for example, a project manager may have to decide how to make sure that team members are working in the project's best interest. Then choose to monitor and or incentivize team members. There may even be cases where those who are not performing would be at risk of losing their jobs. Similar to this idea of a change in control. So the control mechanisms that we see here, there are important tools that managers can use to design systems that help ensure that employees pursue the purposes and the goals of the organization.

Lesson 1-6: Natural System View of Governance

[Lesson 1-6.1: Natural System View of Governance]



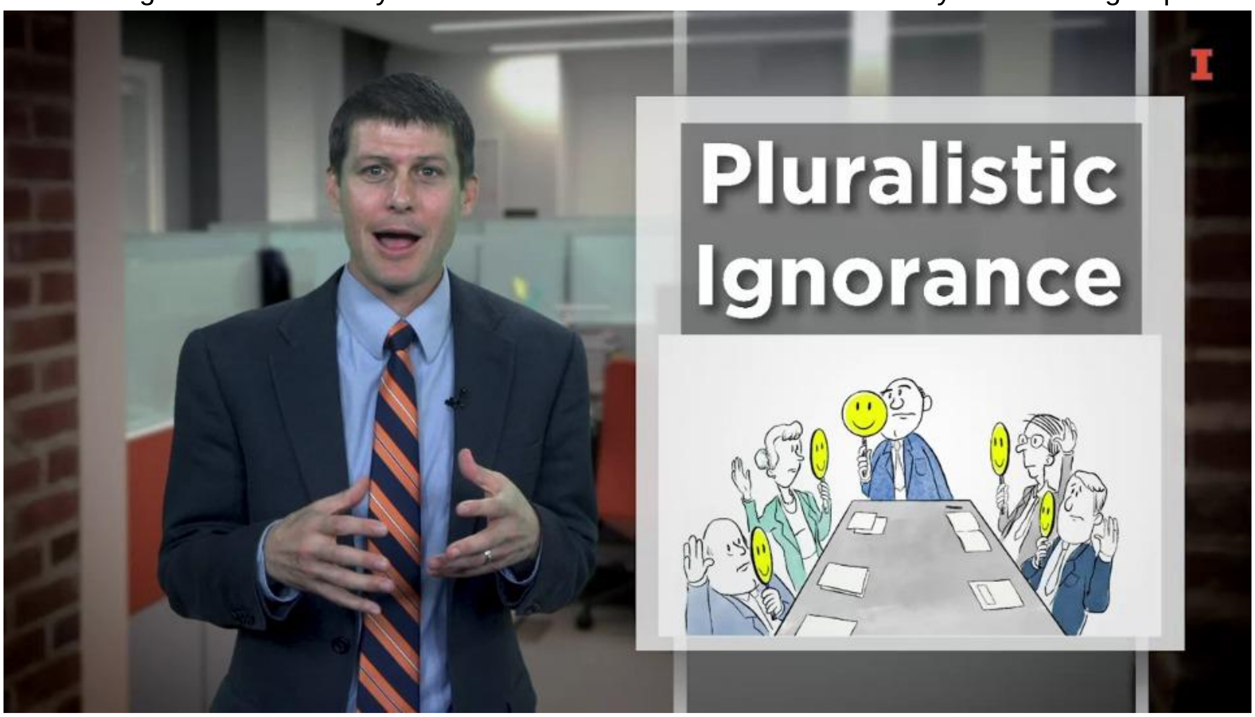
[MUSIC] Agency theory is a useful way to think about control and organizations. If you think about our three lenses, agency theory is really a rational system view of the firm. So that means there's lots of focus on structural aspects of the board and the idea that getting the right incentives in place will lead to better performance. But it also tends to minimize the human aspect of good governance.



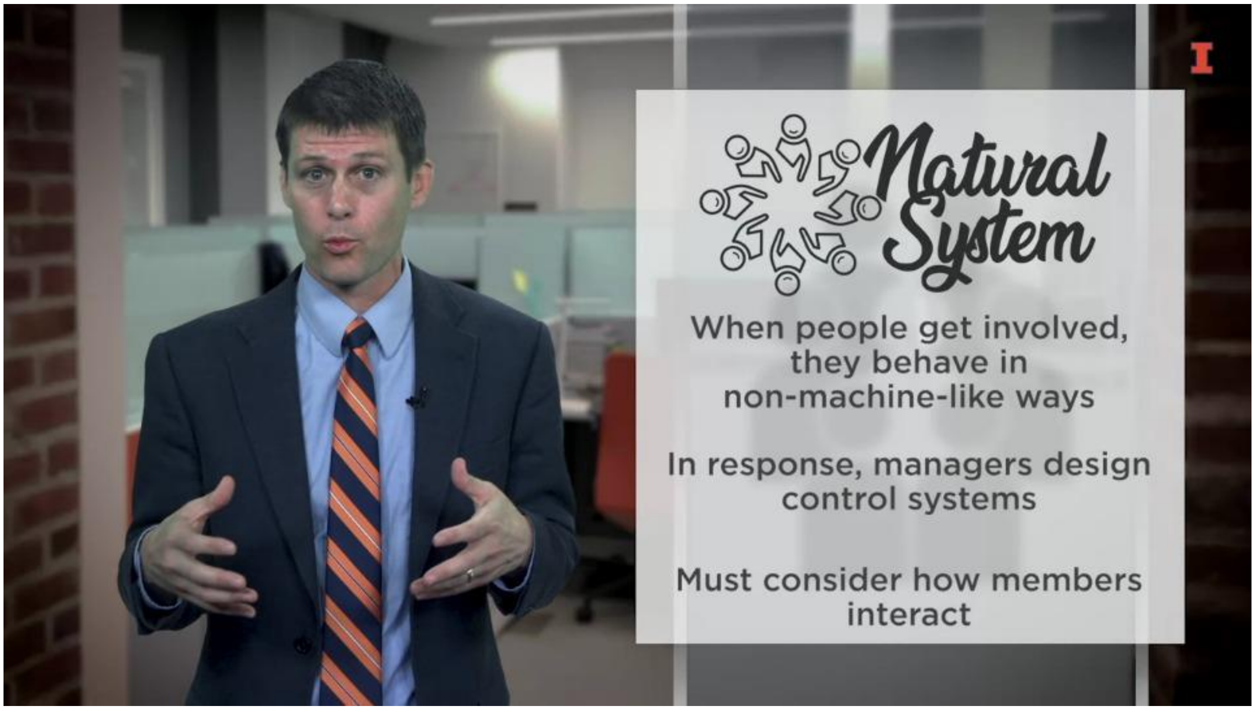
So while agency theory has received lots of attention and has really been influential in how we think about effective governance. Research has failed to show strong relationships between a lot of the prescriptions of agency theory and financial performance. So, for example, just having more outsiders on the board or separating the CEO and the board chair position or paying executives with higher percentage of stock. That doesn't necessarily mean that your firm is going to perform better. Now, there's lots of reasons for this. But perhaps, one of the reasons why the prescriptions of age agency theory haven't necessarily delivered their promised results is that it's something that we've discussed before about the different perspectives on organizations. Like the shareholder value perspective, agency theory takes a machine like view of governance and control.

So perhaps to understand more fully what good governance is, we need to use a natural system lens. To better understand the people who are involved at the top of organizations. Remember, when we view the organization from a natural system lens, we see the people involved and we start to see some of the messiness that people bring. Let me give you an example of a natural system view of the board of directors for my own research. One of the conclusions from this research is it turns out that directors are people, too. And they suffer from some of the same decision-making biases that you and I do.

There's a phenomenon called the Abilene Paradox made famous years ago by a professor named Jerry Harvey. He tells the story of sitting on the front porch at his in-laws house in West Texas, sipping lemonade and chatting with his wife and his in-laws. Out of the blue, his father-in-law suggests that they get in the car and they drive to Abilene to go eat.
Jerry wife's Jerry's wife says, hey, that sounds like a great idea. Now, Jerry, he did not want to go to Abilene. It was a hot day. The car didn't even have air conditioning and it was an hour long trip over a dusty road. But Jerry is a smart man and he understands that when your father-in-law and your wife both makes a suggestion, the right answer is, of course, I want to go. So his mother-in-law then agrees to go as well. And so they hop in the car and they make the trek to Abilene, Texas. They eat at the cafeteria where it turns out the food wasn't that good, then they turned around and they came home. As they returned home, Jerry said, hey, what a great trip. His mother-in-law looked at him and said, actually, I didn't enjoy it at all and I would have rather stayed home. Jerry's wife then said, I didn't want to go either but I thought everybody else did. Even the father-in-law who suggested the idea said, I didn't want to go but I just thought everybody looked bored. So what they discovered was that individually, none of the four of them wanted to go to Abilene and yet somehow that was the decision that they made as a group.



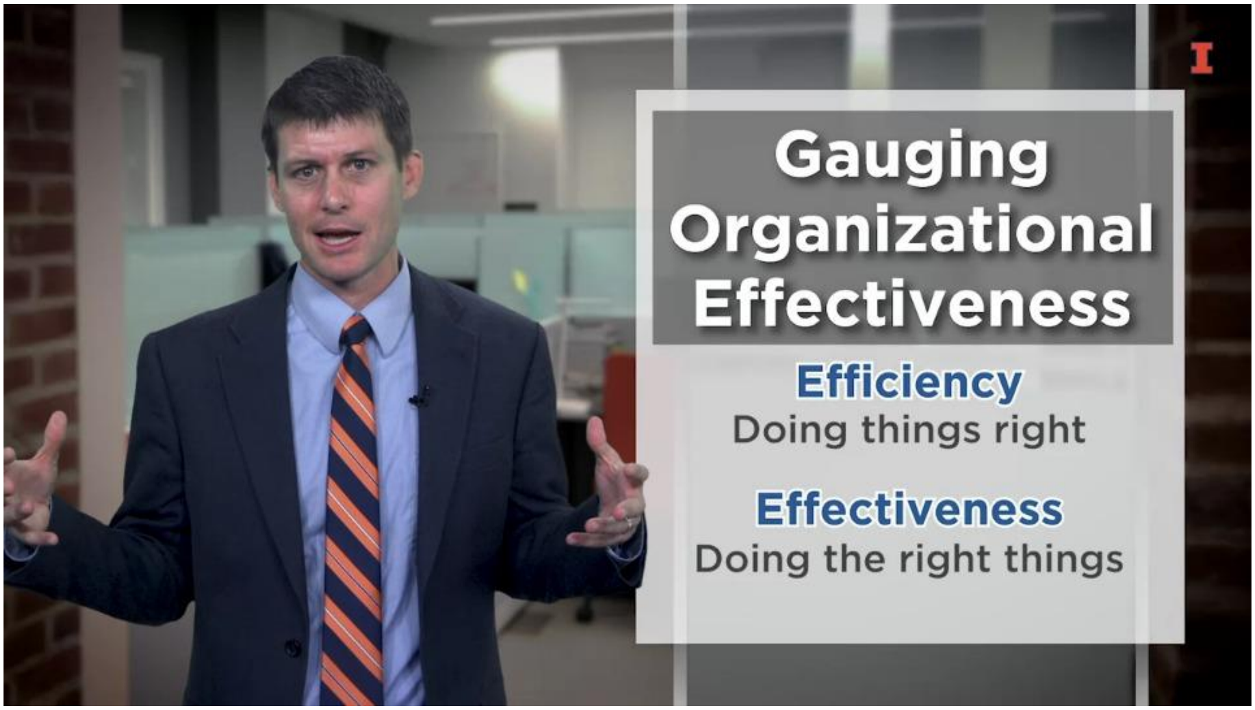
Well, in social psychology, there's a name for this. It's called pluralistic ignorance. And pluralistic ignorance is a situation where individuals have private concerns about something but they underestimate the level of concern that everyone else shares. Maybe you've experienced something like this in a classroom. Maybe you've had a professor like me droning on and on where the whole classroom is confused and then the professor asks, does anybody have a question? Everybody looks around, they see that nobody else is raising their hand, nobody wants to be the only one to admit they're confused. And so you get this weird dynamic where even though every single person is confused, no one raises their hand and ask you a question. Well, it turns out that a similar dysfunctional dynamic can happen among directors. Several years ago, I was part of a research team that collected survey data from a large sample of board members. Now, these directors were asked to rate their own level of concern with their firm strategy and also rate how concerned they thought other directors were. In the lower performing firms in our sample, we found that directors who had high levels of concern about the firm strategy, they typically thought that other directors were less concerned. And as you saw that gap grow between an individual director's concern about strategy and their perception of other director's concern, then those directors were less likely to raise concerns in board meetings. Ultimately, this dysfunctional decision-making bias was shown to contribute to firms continuing with failing strategies even in the face of poor performance.



This example highlights the fact that when we think about governance, we need to think about the individuals that are involved. In other words, it can be useful to apply a natural system lens where we recognize that when people get involved, they often behave in non machine like ways. So as a manager as you design Control Systems while it's important to get the right structures and the right incentives in place. You also want to think about how members of your team or your organization interact. So for instance, part of designing an effective governance system is creating in a culture where people can express concerns in an open in a forthright way. Ultimately getting the right people in place and helping them to interact in productive ways is an important part of effective governance.

Lesson 1-7: Gauging Organizational Effectiveness

[Lesson 1-7.1: Gauging Organizational Effectiveness]



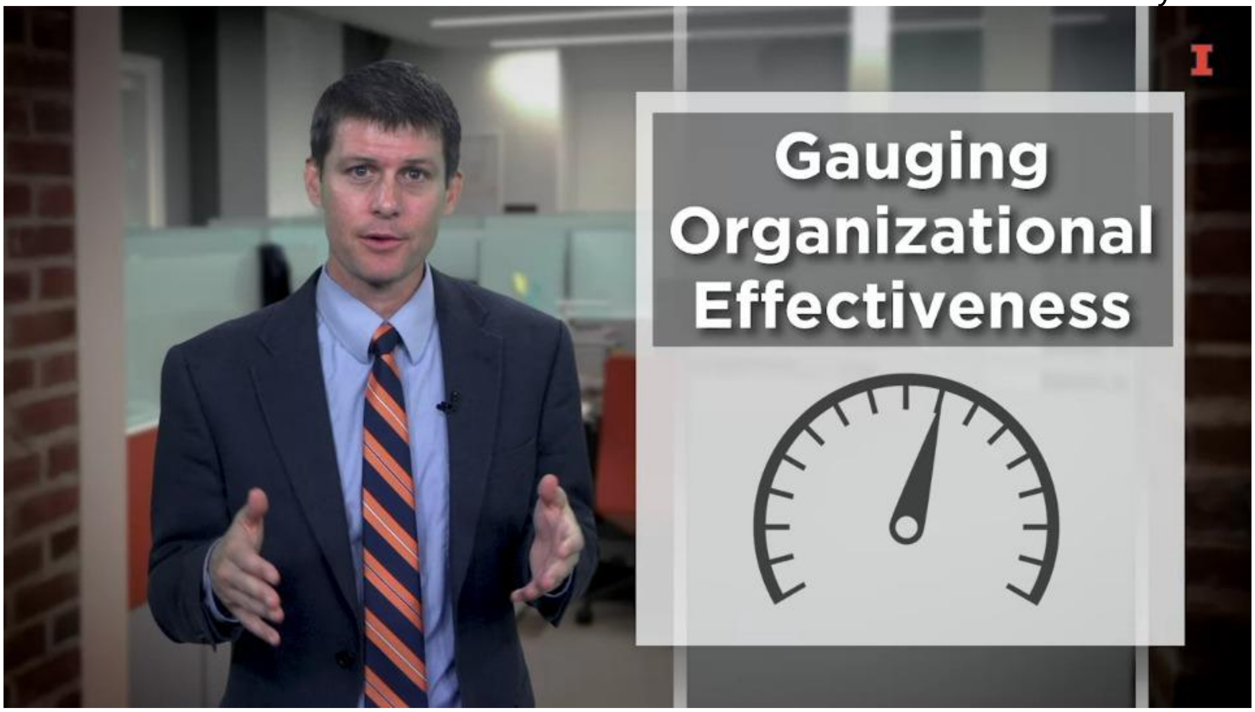
So how do we know if we're successful at achieving our intended purpose? How do we measure success? What are the criteria we should use? It turns out that these can actually be pretty difficult questions to answer. In trying to understand if we are successfully achieving our purpose, it might be helpful to articulate the difference between efficiency and effectiveness. I've heard it said that efficiency is doing things right, effectiveness is doing the right things. Organizations are effective to the extent that they achieve their intended purposes. Efficiency is about maximizing your results without wasting time and resources. Efficiency is an important part of effectiveness, but it is also possible to become really good at doing the wrong things. So organizational effectiveness is a broader measure of success that includes organizational efficiency.

Now if we go back to our three lenses, these perspectives can help us to determine if we are effective or not. If we view the organization as a machine or a rational system, we're probably going to focus on efficiency related indicators of success. So we're likely to measure success using financial metrics like profitability. We might look at how smooth our internal processes are running and look at outcomes related to quality. We would be concerned with the inputs coming in and the outputs going out.

Now if we take more of a natural system approach, we're going to look at factors related to the people inside the organization. We may gauge success based on the skills and the competencies of our employees. We could examine our employee retention and focus on the culture of the organization. Now these things are pretty hard to measure, but they're important things to consider as we think about the success of the organization.

Finally, if we take more of an open system approach, we may be more concerned with how the organization is getting resources in from the outside world. We try to measure the firm's ability to adapt. We try to gauge how well the firm is meeting the needs of a variety of different stakeholders.

Now, many firms use a broad, multifaceted approach to try and measure organizational effectiveness. Sometimes it's referred to as a balanced scorecard. In the typical balanced scorecard, the firm measures key performance indicators in four different buckets. The financial category or the financial bucket is pretty self-explanatory. It's usually possible to figure out a number of relevant metrics to gauge financial performance. The operational category focuses on the efficiency and quality of internal processes and outputs. The third category, often called learning and growth, is focused on the people, the human capital of the organization. Finally, the customer or the stake holder bucket would have measures to indicate how well we're meeting the needs of various stakeholders. Now you'll notice that the financial and the operational categories represent more of a rational system approach to measuring effectiveness. Learning and growth is more of a natural system approach, and the stakeholder category is more of an open system approach. Now, oftentimes we're pretty good at the financial and the operational categories, partly because those things are usually, typically easier to measure. But if we can figure out appropriate measures for the other categories related to people and stakeholders, those are often leading indicators of the success of the firm. Many times, financial metrics are lagging indicators. So by the time we see a problem in the financials, it's too late to do much about it.



So as a manager, it's once again important for you to be able to view your organization or the relevant parts of your organization through each of the three lenses that we've been talking about so far. This is especially true when gauging organizational success. The best managers carefully craft key indicators of organizational success that represent each of our three perspectives.