

A 3D bar chart with three bars of increasing height from left to right. The bars are rendered in a light beige color with a slight shadow, set against a light beige background. The chart is positioned behind the title text.

# GROWING PAINS

TRANSITIONING FROM AN ENTREPRENEURSHIP  
TO A PROFESSIONALLY MANAGED FIRM

ERIC G. FLAMHOLTZ  
& YVONNE RANDLE

FOREWORD BY ANGELO R. MOZILO, CHAIRMAN & CEO, COUNTRYWIDE FINANCIAL CORPORATION



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*Transitioning from an Entrepreneurship to  
a Professionally Managed Firm*

*Fourth Edition*

Eric G. Flamholtz  
Yvonne Randle

Foreword by Angelo R. Mozilo

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## PREFACE

**D**uring the latter part of the twentieth century, as well as in the early years of the new millennium, we have witnessed an explosion in entrepreneurship. Companies in areas as diverse as bioengineering, pizza, computers, women's fashion, chocolate chip cookies, printing, publishing, distribution, real estate, and electronic commerce, to cite a relatively few, have flourished. Some entrepreneurships, including Microsoft, Starbucks, Wal-Mart, PowerBar, eBay, Dell Computers, Amazon.com, Countrywide Financial Corporation, and Southwest Airlines, have become spectacular successes and household names. Many more relatively unknown firms have also been very successful.

In some cases, entrepreneurial firms have led to the creation of entirely new industries; in other cases, they have achieved tremendous success because their founders were able to see their business a little differently. Entrepreneurs, in fact, are responsible for one of the most significant developments of the past forty years: the personal computer. It may seem difficult to imagine that less than thirty years ago, few people had access to computers and that those who did spent their time in large rooms located in laboratories, schools, and businesses. They worked at terminals connected to a mainframe or spent their time preparing punch cards that contained programs. Less than twenty years after they released the first Apple Computer, the vision of Steve Jobs and Steve Wozniak (the founders of Apple Computer) that each person would own a computer became a reality. Today, the average person *can* own a computer, which has the power not only to help the person be more productive but also

can serve as a means through which to stay connected to others throughout the world. The power of the Internet provides personal-computer users with the ability to communicate with people throughout the world, obtain information on practically any topic, and buy and sell products—all from their homes or offices. The existence of e-commerce has served as a platform for the emergence of additional entrepreneurial companies all over the world.

While the efforts of some entrepreneurs have led to the development of entirely new industries, other entrepreneurships have achieved tremendous success in existing industries. Firms like Southwest Airlines, Starbucks, and Nike emerged in industries that already existed, but they became enormously successful, in part, by creating new ways of providing existing products or services, or both.

Now that we have entered the new millennium, the focus on entrepreneurship seems not only to be continuing but also expanding. Most leading business schools provide their MBA students with courses on this topic, and many have entire programs dedicated to entrepreneurship.

With all of this focus on entrepreneurship, however, a significant number of firms still experience problems and sometimes fail as they grow and develop beyond the initial “new venture stage.” A key question, then, is this: Why do some entrepreneurial firms (like Starbucks, Nike, Southwest Airlines, and Microsoft) continue to be successful, while others (like Boston Market, LA Gear, People Express, and Osborne Computer) experience problems and even failure? Addressing this question has been the focus of our research and consulting over the past thirty years. This is also the question that we seek to address in this book.

In brief, our research and practical experience in working with entrepreneurial organizations over the past thirty years suggests that all organizations experience growing pains as a normal part of their development. Growing pains indicate that the company has outgrown its infrastructure and that it must develop new systems and processes, as well as a new structure, to support its size. When firms ignore growing pains, significant problems and even failure can result.

The purpose of this book, then, is to help present and potential managers and others understand what it takes to continue to grow successfully after a new venture or entrepreneurship has been started. It provides a lens, or framework, to help people understand how to manage organizational growth successfully in entrepreneurial organizations. It also presents and describes a set of tools that can be used to minimize growing pains, which are an inevitable part of successful organizational development.

This is the fourth edition of *Growing Pains*. The first edition was published in 1986, the second in 1990, and the third in 2000. We were pleased with the response to the book and the positive comments we have received over

the years. The intent of this edition is to update the book with new ideas and concepts, which we have developed over the past few years, as well as with new examples and cases of companies. The basic structure and format of the book, which has proved valuable to entrepreneurs, managers in entrepreneurial organizations, students in MBA programs, venture capitalists, and bankers, remains the same. Our aim was to enhance and update the book to make it even more valuable for the new millennium, as it is based on our new research and experience.

## ENTREPRENEURSHIP VERSUS PROFESSIONAL MANAGEMENT

The basic theme of the book, as indicated by its subtitle, is how to make the successful transition from an entrepreneurship to a professionally managed firm. Some people may conclude that because we suggest that entrepreneurs must make transitions and become something other than what they are, we are negative about entrepreneurship. This is hardly the case. We admire the entrepreneur, not only as an individual willing to bet his or her future on an idea but also as the critical element of our economy and the vanguard of the future. In addition, we believe that entrepreneurship *as a state of mind* is an essential component of an organization's culture and must be preserved. An organization must always continue to be "entrepreneurial" in the sense of seeking out new opportunities and innovating, both in terms of new products and processes. But we believe that at some stage of growth, entrepreneurship is not sufficient and that the nature of the organization must change, together with the people who run it.

The term *entrepreneurship* has, in current usage, taken on meanings that are somewhat different from its original meaning. In the classic sense, the *entrepreneur* is someone who creates a business, and an *entrepreneurship* is a business that has been created where none previously existed. In informal usage today, the term *entrepreneurship* seems to have the connotation of a certain way of managing a company. It appears to imply a very informal approach to management or, at the other extreme, the total lack of management of a firm. Because many initially successful entrepreneurs seem to be lacking in formal systems or procedures, or even a structure, many people incorrectly assume that these things are not required for successful organizations. The assumption, either explicit or implicit, is this: "We got started without formal systems and processes, and we are successful, so we clearly do not need them." In addition, some people point to giant companies like AT&T, General Motors, and U.S. Steel, to cite just a few, where formal systems and procedures have been carried to such an extreme that the company has become mired in bureaucracy. Therefore, it follows that having formal procedures can actually

be a weakness for organizations. Both of these viewpoints, while undeniably attractive, are essentially simplistic.

Although it is true that having well-defined and formal processes for managing the business is often not a decisive factor in determining the success of a new venture, we believe (and will demonstrate throughout this book) that developing certain systems and processes is essential if a firm is to continue to grow successfully and profitably throughout its life cycle. In addition, although it is true that many firms choke on their own bureaucracy, it is not because these firms have formal systems; rather, it is because of the way these organizations use their systems. Moreover, some firms, such as Compaq Computers (which merged with Hewlett-Packard in 2002) and Federal Express, were, in fact, professionally managed entrepreneurships from their inception (as discussed in Chapter Five), and this led to their spectacular success.

For some people the term *professional management* has negative connotations. They see it as synonymous with *bureaucracy*. The fact that a firm is professionally managed does not mean that the entrepreneurship must inevitably become bureaucratic. In our view, a professionally managed firm has achieved the best of both worlds. It is entrepreneurial without entrepreneurship being its only strength; it is well managed without becoming choked on its own systems and procedures. An analogy might be a great sports team that has an excellent offense as well as a superb defense. Entrepreneurship is the essence of an organization's offense, while effective management is the essence of its defense. Just as a great defense can create opportunities for the offense, so can the systems, processes, and structure initiated by professional managers create opportunities for entrepreneurship.

The basic message we want to convey is this: *entrepreneurship, as a state of mind and a component of culture, must continue, regardless of the size of an enterprise*. However, the form of an entrepreneurial organization must change over time as it grows and increases both in size and complexity. It must evolve from a "pure" or early-stage entrepreneurship to what we have termed an *entrepreneurially oriented, professionally managed* firm. This is not a bureaucracy (an organization must never become bureaucratic), but it must inevitably change and develop more formal processes if it wants to maximize the likelihood of continuing to be successful. These make up, as we explain in Chapter One, the infrastructure required to facilitate future growth, just as a building's foundation provides the platform for its elevations. If an organization does this and it becomes an entrepreneurially oriented, professionally managed firm (or what we refer to throughout this book as simply a professionally managed firm), then it is likely to continue to grow and develop successfully, just as Starbucks, Countrywide Financial Corporation, and Microsoft have each done. If it does not do this at all or not sufficiently well, then it is likely to experience difficulties (for example, Sun Microsystems, Sybase, AOL), or

even fail, just as Osborne Computer, Boston Market, and Maxicare did. We examine examples like these in this book and explain how firms like Starbucks have successfully made the transition from entrepreneurship to professional management while companies like Boston Market did not.

For many people the term *entrepreneurship* has the connotation of a small firm, but that is not how the term is being used here. There are many examples of large entrepreneurships, especially as we enter the electronic age, when firms such as eBay, Yahoo!, and Amazon.com can become very large almost overnight. There are also companies that are smaller in size (as measured by revenues or number of employees) that are merely small businesses and not entrepreneurial in any sense of the word.

When we use the terms *entrepreneurship* or *entrepreneurial company*, we are referring to the entrepreneurial ethos or mind-set and not to a particular size of firm. We are also referring to an organization that has not made the transition to a professionally managed firm. Similarly, when we use the term *professionally managed*, we are referring to a firm that has retained the entrepreneurial spirit, while at the same time developing the systems required to effectively manage the much larger firm it has become. In this sense, we use the terms *entrepreneurially oriented*, *professionally managed firm*, and *professionally managed firm* interchangeably.

## INTENDED AUDIENCE

This book is addressed principally to the owners, managers, and employees of entrepreneurial companies (including not-for-profit companies), to investors, bankers, and venture capitalists, and to students and scholars of management who are interested in the success and failure of entrepreneurships. It focuses on the question, Why, after successful or even brilliant beginnings, do entrepreneurial companies often lose their way? More important, it explains what all companies, especially those at the entrepreneurial stage, must do to be successful as they grow and describes the transitions they must make to survive. Case studies of entrepreneurial companies at different stages of growth, drawn from a wide variety of industries, are included to illustrate different aspects of the transitions that must be made. The cases also show how the frameworks provided in this book can be used as conceptual maps of what needs to be done by an organization at each developmental stage. In addition, the book specifies the adjustments the founder or CEO of an entrepreneurial company needs to make so that he or she can grow with the organization, as did Howard Schultz at Starbucks, and not be left behind.

The book is also addressed to those interested not only in entrepreneurships but in established companies as well. Although it has been positioned

primarily to help managers and scholars understand the problems and processes related to managing the transition from an entrepreneurship to a professionally managed firm, the underlying framework and content are applicable to all organizations, including large companies. (See, for example, the Foreword by Angelo Mozilo, founder and CEO of Countrywide Financial Corporation, about the relevance and application of the concepts and approach in his company.)

Specifically, the book is based on two different but related conceptual frameworks: (1) an organizational effectiveness model and (2) an organizational life-cycle model. The organizational effectiveness model, termed the Pyramid of Organizational Development (discussed in Chapter One) explains the variables that must be managed by companies to give them the optimal (most likely) chance of long-term success. The life-cycle model (discussed in Chapter Two and in Chapter Fourteen) identifies seven stages of growth from a new venture (corporate birth) to an established organization in decline and requiring revitalization. The book can, therefore, be viewed as providing a comprehensive framework for managing a company throughout its life cycle but especially as focusing on the stages of growth after its inception and until it reaches maturity as a professionally managed firm.

The book is also appropriate for companies that think of themselves as professionally managed but have begun to lose some of their momentum and may even have lost their entrepreneurial spirit. It can show them what has to be done to make the transition to an entrepreneurially oriented, professionally managed firm rather than a bureaucracy. Accordingly, we cite examples ranging from relatively small new ventures and medium-sized companies to very large organizations such as IBM.

## OVERVIEW OF THE CONTENTS

This book is divided into five parts. Part One presents a conceptual framework for managers of entrepreneurial organizations to use in understanding what is happening to their firms and what they must do to reach the next stage successfully. The framework includes the six key factors for developing an effective, profitable organization and descriptions of the successive stages of growth at which transitions must be made. Part One also describes the organizational growing pains that are common in rapidly growing firms and presents a method for assessing the extent to which an organization suffers from them.

Part Two presents a series of organizational case studies as a vehicle for examining what an organization must do to develop successfully from one stage to the next. Specifically, Part Two presents examples of companies at each

of the first four critical stages of growth, from new venture to organizational maturity. It describes the problems those companies faced and explains how such problems need to be dealt with as an organization grows.

Part Three presents the most significant managerial tools that entrepreneurial organizations must master if they are to grow and develop successfully and profitably: strategic planning, organizational structure, management development, organizational control, leadership, and corporate culture management. Although the tools of planning, structural design, and the like may be, at least superficially, familiar to some readers, our approach to these key components of a management system differs in some respects from other books; there is also an integrative aspect to the set of management systems components overall.

Part Four deals with some advanced issues and topics relating to organizational development and transitions. It includes a discussion of the advanced aspects of strategic planning. It also presents a preview of the problems to be faced by companies as they grow beyond the early entrepreneurial stages to the more advanced stages of organizational growth. In addition, it deals with the questions and issues involved for those entrepreneurial companies that decide to “go public.” It is intended to be an introduction rather than a comprehensive treatment of these issues.

Part Five deals with the personal aspect of organizational transitions. It discusses the issues involved in managing and growing family businesses. It also deals with the issues facing the presidents or CEOs of entrepreneurial organizations; it is designed to help them focus on what needs to be done to successfully grow their firms and to help them grow personally along with their firms.

This fourth edition of *Growing Pains* differs from the third edition in several important respects. Although the overall direction and thrust of the book have been retained, all chapters have been revised to update material and references to companies, as appropriate. However, in some instances we have kept certain examples (such as Osborne Computers) and cases (Metro Realty and Tempo Products) because they are “classic,” or prototypical, of the points we want to make, or because there are no better current examples, or because of their historical significance. Three new chapters have been added, dealing with the issues of advanced strategic planning, family business transitions, and going public. In addition, we have cited new empirical research that has been published during the past several years that supports the framework and ideas presented in the book.

Throughout the book, several new cases, examples, or “mini-cases” of companies dealing successfully or unsuccessfully with transitional issues have been added, including examples from companies such as Infogix (software), 99 Cents Only Stores (discount merchandise), PeopleSupport (outsourcing), and Countrywide Financial Corporation (mortgage and finance). New conceptual material has also been added to most of the existing chapters. New

mini-cases and international examples of entrepreneurship have been added because of the widespread flourishing of entrepreneurship around the globe, including examples from Europe, Australia, and Asia. Chapter Thirteen includes a comprehensive example of an entrepreneur who was born in India and developed a very successful company in the United States. A number of cases (including Starbucks, Osborne Computer, Apple Computer, and Bell-Carter Foods) are used throughout the book to provide a consistent frame of reference for the perspective being developed. To a considerable extent, we have drawn on examples of companies where we have in-depth knowledge. In some cases, to protect the privacy of individuals and organizations, we have disguised the company's and individuals' names.

Entrepreneurship is a driving force in today's economy. Accordingly, entrepreneurial companies must be successful, not only for the good of the entrepreneurs and their employees but also because of the benefits to the general economy. Unfortunately, too many entrepreneurial companies flounder after promising or even brilliant beginnings. Companies such as Boston Market, People Express, Maxicare, and Osborne Computer were all once cited as great entrepreneurial successes, yet all have failed. In the face of these failures and difficulties, some cynical observers have even begun to define an entrepreneur as someone, such as Adam Osborne (who created the first portable computer) or Robert Campeau (a Canadian shopping center developer), who can start and build a company to a given level and then watch it fail.

Our experience in doing research and consulting with entrepreneurial companies has led us to write this book to help present and potential entrepreneurs, as well as their employees, advisers, and venture capitalists, understand the pitfalls typically faced by entrepreneurial organizations at different stages of growth and to explain how to make the successful transition to a professionally managed firm. It is also intended to help governmental policymakers understand the causes of the premature demise of entrepreneurial companies that are so vital to our economy. Although this book will not solve all the problems faced by entrepreneurial companies, our experience, as well as the positive feedback we received about the previous editions, indicates that if the ideas and methods described in this book are applied, organizations will have a significantly improved likelihood of continued success.

To enhance the value of the book, as well as to illustrate our ideas, we use numerous examples of both successful and unsuccessful—or at least relatively less successful—firms. We are not asserting that the successful companies will always continue to be successful. Indeed, if they do not continue to focus on developing their internal capabilities to meet the demands of their own development, their fortunes can be expected to change. For example, Compaq Computer, which was successful for a very long time, ultimately experienced difficulties and was purchased by Hewlett-Packard. Unfortunately,

nothing is built to last forever. This is why Stage VII in our life-cycle model (see Chapter Fourteen) deals with decline and revitalization. However, there are things that can be done to increase the probability of organizational success at all stages of growth. That is the purpose of our book—to help people interested in building entrepreneurial organizations do so in ways that help increase the probability of organizational success and reduce the probability of failure.

## ACKNOWLEDGMENTS

This work is a product of many years of action research and consultation with many different organizations. These range from new ventures to members of the Fortune 500. They were our research “laboratory.” Simply stated, the most significant ideas that underlie this book were the products of observing, analyzing, and conceptualizing what actually happened in successful and unsuccessful organizations as they grew. The book could not have been written without having had access to those companies of various sizes, in different industries, with different degrees of success. Accordingly, we are greatly indebted to the CEOs, presidents, senior managers, and others who invited us to serve as researchers, consultants, or advisers for their organizations. (Many of these companies are not mentioned by name, to preserve their privacy. In some cases, fictitious names are used; in others, examples are cited without the company being named at all.)

First we want to thank Angelo Mozilo, cofounder, chairman, and CEO of Countrywide Financial Corporation, for his very gracious Foreword. We are honored by his comments and his willingness to write the Foreword to this edition.

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We also want to thank Jeff Haines, founder and former CEO of Royce Medical Corporation, for allowing us to describe his firm’s strategic planning process in Chapter Seven. We appreciate the time he took to review and provide feedback on the case.

Chapter Nine, dealing with the role of management development in the transition from entrepreneurship to professional management, describes the management development program that Bell-Carter Foods has used over the past ten-plus years to help develop its management team. We wish to thank Tim and Jud Carter, CEO and president of the company, for allowing us to describe this program and the results they have achieved. We also thank them for allowing us to share, in more depth, how they addressed the

challenges of making the transition to professional management in a family business (Chapter Sixteen).

In Chapter Ten, we describe Southern California Presbyterian Homes' performance appraisal. We wish to thank Jerry Dingivan, CEO, and the members of his management team for letting us share the approach they used to develop a very effective, goal-driven approach to their appraisal process.

We want to thank 99 Cents Only Stores for permitting use to write a case about them in Chapter Fifteen. We also want to thank Lance Rosenzweig for permitting us to do a case about the process of going public at his company, PeopleSupport. Kathryn Schreiner assisted with the preparation of the PeopleSupport case.

Leslie Ray, then a Ph.D. candidate in UCLA's Anderson Graduate School of Management, did research that served as the basis for the descriptions of Compaq Computer, Mrs. Fields' Cookies, and Federal Express.

Quentin Fleming, then a consultant at Management Systems Consulting Corporation, assisted with several of the case studies that have been included in Chapter Eight on organizational structure.

The late Jason Richler, then a consultant with Management Systems, provided input on the Grange, Inc. case included in Chapter Three.

The Price Institute for Entrepreneurial Studies, under the direction of Alfred E. Osborne, provided financial support for research assistance to prepare some of the case studies presented in this book. We both have used this book as a text in a course we designed titled "Managing Entrepreneurial Organizations" in the Anderson School of Management at UCLA for many years.

The book has also been used in management development programs for our clients offered by our firm, Management Systems Consulting Corporation.

We want to thank Jennifer Han for help in preparation of the final manuscript formatting for this book at Management Systems Consulting Corporation. Laurie Flamholtz also assisted with this preparation. Special thanks go to Michel Tan, M.D., who saved days of work with a skillful computer data recovery at a critical time!

The data presented in Chapter Three are drawn from the organizational effectiveness database compiled by Management Systems Consulting Corporation. They are derived from a survey developed by Eric Flamholtz. Lily Arguello, then a junior consultant with Management Systems, assisted in the preparation and interpretation of the data (updated from the second edition) dealing with organizational growing pains (Chapter Three).

We are indebted to the Jossey-Bass staff for the highly professional and competent way in which this project was handled. They were enthusiastic about this book from its inception and supportive throughout its execution.

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Although we acknowledge with gratitude the contributions of all those cited, we remain responsible for the book and its imperfections.

Eric G. Flamholtz  
Yvonne Randle  
*Los Angeles*  
September, 2006



## PART ONE



# A FRAMEWORK FOR DEVELOPING SUCCESSFUL ORGANIZATIONS

The first challenge entrepreneurs face is that of establishing a successful new venture. The basic skills necessary to meet this challenge are the ability to recognize a market need and the ability to develop (or to hire other people to develop) a product or service appropriate for satisfying that need.

If these two fundamental things are done well, a fledgling enterprise is likely to experience rapid growth. At this point, whether the entrepreneur recognizes it or not, the game begins to change. The firm's success creates its next set of problems and challenges to survival.

As a result of expanding sales, the firm's resources become stretched very thin. A seemingly perpetual and insatiable need arises for more inventory, space, equipment, people and funds. Day-to-day activities are greatly sped up and may even take on a frenzied quality.

The firm's operational systems (those needed to facilitate day-to-day activities), such as marketing, production or service delivery, accounting, credit, collections, and personnel, typically are overwhelmed by the sudden surge of activity. There is little time to think, and little or no planning takes place because most plans quickly become obsolete. People become high on their own adrenaline and merely react to the rush of activity.

At this point the firm usually begins to experience some, perhaps all, of the following organizational growing pains:

- People feel that there are not enough hours in the day.
- People spend too much time “putting out fires.”

- Many people are not aware of what others are doing.
- People lack understanding of where the firm is headed.
- There are not enough good managers.
- People feel that “I have to do it myself if I want to get it done correctly.”
- Most people feel that the firm’s meetings are a waste of time.
- When plans are made there is very little follow-up, so things just don’t get done.
- Some people feel insecure about their place in the firm.
- The firm has continued to grow in sales, but not in profits.

These growing pains are not merely problems in and of themselves; they are a symptom of an “organizational development gap” between the infrastructure required by the organization and the infrastructure it actually has. An organization’s infrastructure consists of the operational support systems and management systems required to enable the organization to function profitably on a short- and long-term basis. As described more fully in Chapter One, a company’s operational support systems consist of all the day-to-day systems required to produce a product or deliver a service and to function on a day-to-day basis. Management systems consist of the firm’s planning system, organization structure, management development system, and control-performance management systems. These are the systems required to manage the overall enterprise on a long-term basis.

## **THE SECOND CHALLENGE FOR ENTREPRENEURS**

Once a firm has identified a market and has begun to produce products or services to meet the needs of customers within that market, it will begin to grow. As the firm grows, it will be faced with the need to make a fundamental transformation or metamorphosis from the spontaneous, ad hoc, free-spirited enterprise that it has been to a more formally planned, organized, and disciplined entity. The firm must move from one in which

- There are only informal plans, and people simply react to events to one in which formal planning is a way of life.
- Jobs and responsibilities are undefined to one in which there is some degree of definition of responsibilities and mutually exclusive roles.
- There is no accountability and no control system to one in which there are objectives, goals, measures, and related rewards specified in advance, as well as formal performance appraisal systems.

- There is only on-the-job training to one in which there are formal management development programs.
- There is no budget to one in which there are budgets, reports, and variances.
- Profit simply happens to one in which there is an explicit profit goal to be achieved.

In brief, the firm must make the transition from an entrepreneurship to an entrepreneurially oriented, professionally managed organization.

As we see in Chapter Seventeen, this is a time when the very personality traits that made the founder-entrepreneur so successful initially can lead to organizational demise. Most entrepreneurs have either a sales or technical background, or they know a particular industry well. Entrepreneurs typically want things done in their own way. They may be more intelligent or have better intuition than their employees, who come to rely on their bosses' omnipotence. Typical entrepreneurs tend to be doers rather than managers, and most have not had formal management training, although they may have read the current management best-sellers. They like to be free of corporate restraints. They reject meetings, written plans, detailed organization of time, and budgets as the trappings of bureaucracy. Most insidiously, they think, "We got here without these things, so why do we need them?"

Unfortunately, at the stage of corporate development we are discussing, the nature of the organization has changed—and so must the firm's senior management. The owner-entrepreneur can deal with the situation in one of five different ways. He or she can

- Try to develop new skills and behavior patterns—difficult but quite possible.
- Retire, as Phil Knight did at Nike, and let others bring in a professional manager to run the organization.
- Move up to chairperson, as Howard Schultz did at Starbucks, and turn over operations to a professional manager while still staying involved.
- Continue to operate as before and ignore the problems, hoping they will evaporate.
- Sell out, as Steven Jobs did in 1985 at Apple Computer, and start another entrepreneurial company.

Founder-entrepreneurs typically experience great difficulty in relinquishing control of their businesses. Some try to change their skills and behavior but fail. Others merely give the illusion of turning the organization over to professional managers. For example, one successful entrepreneur brought two very highly paid and experienced managers into his firm, made a great flourish about

the transition, and then proceeded to turn them into managerial eunuchs who lacked real power. After they had (predictably) failed, he was able to “reluctantly” resume control of the enterprise and plead that he had made every effort but the business obviously could not do without him.

There is no one pattern for a successful transition from an entrepreneurship to a professionally managed firm. Whatever path is followed, the key to a successful change is for the entrepreneur to recognize that a new stage in the organization’s life cycle has been reached and that the former mode of operation will no longer be effective.

## MAKING AN ORGANIZATIONAL TRANSITION

Once the entrepreneur has recognized that the company’s mode of operation must be changed, the inevitable question arises: “What should we do to take the organization successfully to the next stage of growth?” To answer this question satisfactorily, it is necessary to understand that there are predictable stages of organizational growth, certain key developmental tasks that must be performed by the organization at each growth stage, and certain critical problems that organizations typically face as they grow. This understanding, in turn, requires a framework within which the determinants of successful organizational development may be placed. We present such a framework in Part One of this book.

Chapter One presents a holistic framework for successful organizational development. It deals with the issue of what makes an organization successful and profitable. Drawing on research and experience from consulting with many organizations, it presents a systematic approach to understanding the six critical variables in organizational effectiveness. It examines the six critical tasks of organizational development and describes what must be done to accomplish each task. These six variables or tasks are conceptualized as a Pyramid of Organizational Development.

Chapter Two identifies seven different stages of organizational growth, from the inception of a new venture through the early maturity of an entrepreneurial organization, and to the ultimate decline and revitalization of a company. The chapter then examines the first four stages of growth (the remaining three are discussed in Chapter Fourteen) and examines the relative emphasis that must be placed on each of the six critical developmental tasks at each stage of the organization’s growth.

Chapter Three examines the growing pains that all developing organizations experience. It provides a method for assessing these growing pains and determining their severity. Senior managers need to be able to recognize

such growing pains as symptoms of the need to make changes in their organizations.

Taken together, the ideas in Chapters One, Two, and Three provide a conceptual map of the tasks that must be focused on to successfully manage and develop an entrepreneurial organization. Part One also provides a guide for analyzing and planning the transitions that must be made in moving a company from one developmental stage to the next.

# How to Build Successful Companies

## *The Pyramid of Organizational Development*

The senior management of a rapidly growing entrepreneurial company must simultaneously cope with its endless day-to-day problems and keep an eye on its future direction. Furthermore, the managers of most such companies are going through the process of building a company for the first time. This is about as easy as navigating uncharted waters in a leaky rowboat with an inexperienced crew while surrounded by a school of sharks. The sea is unfamiliar, the boat is clumsy, the skills needed are not readily apparent or not fully developed, and there is a constant reminder of the high costs of an error in judgment.

Just as the crew of such a boat might wish urgently for a guide to help them with navigation, training, and ship repair, the senior managers of an entrepreneurial company may frequently wish for a guide to help them build their firm. The crew might also be glad to know that others before them have made the voyage successfully and to hear some of the lessons that the other voyagers learned in the process.

This chapter attempts to provide a guide for senior managers who are faced with the special challenge of building an entrepreneurial company. It gives a framework or lens for understanding and managing the critical tasks that an organization must perform at each stage of its growth. The framework presented in this chapter is an outgrowth of over three decades of research and consulting experience with organizations who have faced and dealt with the need to make a transition from one stage of growth to the next.

As we explain more fully in this chapter, as well as in Chapters Seven and Thirteen, which deal with strategic planning and organizational development, this framework can be used as a template to plan to build an organization such as a new venture. It can also be used as a strategic lens through which to evaluate the effectiveness of an existing organization in terms of its strengths and areas required for further organizational development.

## THE NATURE OF ORGANIZATIONAL DEVELOPMENT

Organizational development is the process of planning and implementing changes in the overall capabilities of an enterprise in order to increase its operating effectiveness and profitability. It involves thinking about a business organization (or any organization, for that matter) as a whole and planning necessary changes in certain key areas in order to help a company progress successfully from one stage of growth to the next. The key areas that require focus include the firm's business foundation, on which the rest of the firm's systems and processes are built, as well as six key organizational development tasks.

### The Foundation of a Business

All business or economic organizations are based on a conceptual foundation that is either explicitly or implicitly defined and consists of three components: (1) a *business definition or concept*, (2) a *strategic mission*, and (3) a *core strategy*. We deal with the development of a business foundation in depth in Chapters Seven and Thirteen, when we address strategic planning. However, at this point we introduce the key dimensions of the business foundation as a basis for understanding the process of building a successful organization over the long term.

**Business Definition or Concept.** The business concept defines what the purpose of the business is—what the organization is in business to do. For example, Coca-Cola is in the beverage business, Federal Express is in the package transportation business, Countrywide Financial Corporation is in the financial services (including mortgages) business, and Disney is in the entertainment business. In the nonprofit arena, Head Start agencies are in the business of providing comprehensive education, health, nutrition, and parent-involvement services to low-income children and their families, while Southern California Presbyterian Homes (whose performance management system is described in Chapter Eight), is in the business of meeting the service and housing needs of older adults.

**Strategic Mission.** The second component of the business foundation is the strategic mission, which defines what the company will try to achieve over a defined period of time (for example, five years or longer). For Countrywide Financial Corporation the long-term strategic mission was to dominate the mortgage business and become the number-one mortgage lender in the United States. For Starbucks the strategic mission articulated in 1995 was to become recognized as the leading brand of specialty retail coffee in the United States.

**Core Strategy.** The third component of the business foundation is the core strategy. This is the central theme around which the company plans to compete to achieve its strategic mission. For Countrywide Financial Corporation the core strategy was initially to be the low-cost provider and build a brand. For Starbucks the core strategy was “ubiquity”—to be everywhere.

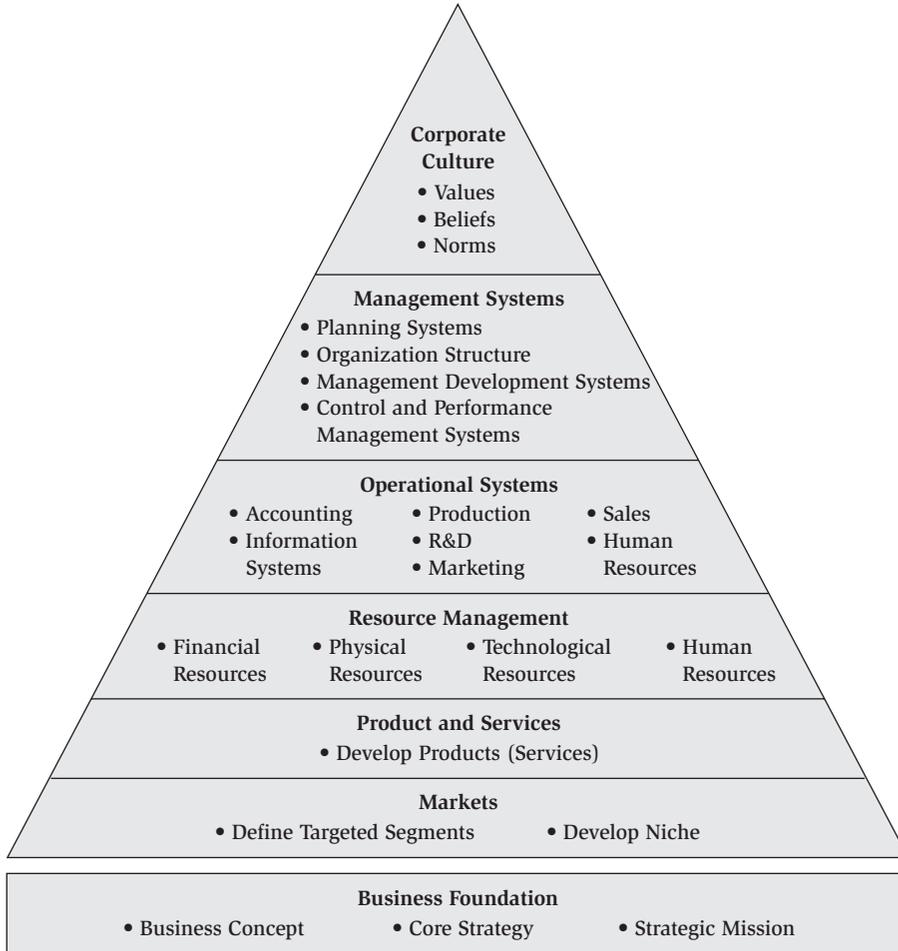
In brief, identifying and clearly articulating a business definition, strategic mission, and core strategy provides the foundation on which all other aspects of the business are—and should be—built. The customers to be served, products offered, and day-to-day systems of the firm should all be built on the business foundation, as explained in the next section.

## Six Key Organizational Development Tasks

Once a firm has identified its business foundation (either implicitly or explicitly), it begins the process of developing the organization that it will support. Our research<sup>1</sup> and consulting experience suggests that there are six organizational development areas or tasks that are critical in determining whether an organization will be successful at any particular stage of growth. Taken together, these six key tasks make up the Pyramid of Organizational Development, pictured in Figure 1.1.

As can be seen in this figure, the pyramid is built on the firm’s business foundation. We first identify and describe each key organizational development task individually and then examine the Pyramid of Organizational Development as a whole.

**Identify and Define a Market and, if Possible, Create a Niche.** The most fundamental prerequisite for developing a successful organization is the identification and definition of a firm’s market and, if feasible, the creation of a market niche. A market is made up of the present and potential buyers of the goods or services, or both, that a firm intends to produce and sell. A market segment is simply a place in the market differentiated by products offered (for example, compact cars, sedans, SUVs, trucks, and buses) or customers served (for example, businesses, schools, and homes). As used here, the term *market niche* is a place within a market where a firm has developed a sufficient



**Figure 1.1.** Pyramid of Organizational Development

number of sustainable competitive advantages so that it “controls” a market segment. Although this distinction is discussed more fully in Chapter Seven, which deals with strategic planning, it should be noted that, in contrast to popular usage and its implicit connotation, a market niche does not have to be small. A true market niche can be very large, as illustrated by Microsoft and its control over most of the operating system software in the personal computer (PC) market. Similarly, Amgen—a leading biotechnology-based pharmaceuticals company—has a niche in the market for kidney dialysis with its product Epogen, controlling over 90 percent of the market. In both Microsoft’s and Amgen’s case, part of their niche is derived from patent protection (the patent

for Epogen, for example, will not expire until 2015). Another and more important contributing factor to the creation of the niche for both of these companies, however, is the focus they have placed on understanding and meeting their customers' needs.

The first challenge to organizational survival or success, then, is identifying a market need for a product or service to which the firm will seek to respond. This can be either a need that has not yet been recognized by other firms or a need not fully satisfied by existing firms. Many nonprofit foundations, for example, are created by individuals or groups who identify unmet or undermet needs of specific populations, raise funds, and then use these funds to meet these needs. The chances for organizational success are enhanced if a firm identifies a need that is not being adequately fulfilled or that has little competition for its fulfillment. This challenge is faced by all new ventures (whether for-profit or not-for-profit); indeed, it is the challenge for a new venture to overcome. It has also been the critical test of growing concerns and has even brought many once proud and great firms to near ruin or total demise.

Many firms have achieved great success merely because they were one of the first in a new market. For example, Apple Computer grew from a small entrepreneurship in a garage to a \$1 billion firm in a few years because its founders identified the market for a "personal" computer. Similarly, Dreyers—a manufacturer of ice cream (now owned by Nestlé)—went from sales of \$14.4 million to sales of \$55.8 million in just five years because the company saw and cultivated a market segment between the "super premium ice creams" such as Haagen-Dazs and the generic (commodity) ice cream sold in most supermarkets. The retailer—99 Cents Only Stores—became a company of approximately \$1 billion in revenues by selling manufacturers' excess products at deep discounts. PowerBar grew from a small basement operation in the mid-1980s to a Stage IV company in the late 1990s by focusing on providing products (including bars) to optimize performance of athletes and nonathletes alike. ("Stage IV" describes a firm that has attained organizational maturity. The stages are discussed more fully in Chapter Two.) Many Internet companies (like Amazon.com and eBay) have also achieved substantial size as a result of developing ways to sell products using this technology.

The reverse side of this happy picture is seen in firms that have experienced difficulties and even failed, either because they failed to clearly define their market or because they mistakenly abandoned their historical market for another. For example, a medium-sized national firm that manufactured and sold specialty clothing wished to upgrade its image and products and become a high-fashion boutique. However, it failed to recognize that its historical market was the "medium" market, and its efforts to rise out of this market were unsuccessful. Similarly, a \$12 million printing company found itself in difficulty after trying to upgrade its position in the medium-priced market.

Attracted by the market segment where the highest-quality work was done (with accompanying high profit margins), the company purchased the best equipment available. It also hired a high-priced sales manager to recruit a salesforce that could compete in the new market segment. However, the company had underestimated the strength of existing companies in that market segment and found itself unable to break into this higher-priced market as easily as managers had hoped. Moreover, the additional investments it had made and the related increases in its overhead made the firm's cost structure higher than that of its former competitors, so it began losing business from its historical market. Thus the company found itself in a cost-price squeeze.

The first task in developing a successful organization, then, is the definition of the market in which a firm intends to compete and the development of a strategy to create a potential niche. This process involves the use of strategic market planning to identify potential customers, their needs, and so on. It also involves laying out the strategy through which the firm plans to compete with others for its share of the intended market. The nature and methods of strategic planning are described in Chapter Seven.

**Develop Products and Services.** The second task of an entrepreneurial organization is *productization*—the process of analyzing the needs of present and potential customers in order to design products or services that will satisfy their needs. For example, Brian and Jennifer Maxwell, who were both runners, saw the need for a nutritious, portable energy food that would assist athletes in achieving optimum performance. This led to the development of PowerBar and, in turn, the development of an entire new category—“energy bars.” Similarly, Michael Dell saw a need to provide PCs directly to customers and began selling them out of his University of Texas dorm room.

Although many firms are able to correctly perceive a market need, they are not necessarily able to develop a product that is capable of satisfying that need adequately. For example, many dot-coms, such as Web Van, identified a potential market need but were unable to develop viable businesses. Many firms developed coffee bars or cafés, but Starbucks has grown to dominate this market. Clearly, being the first to recognize a need is not necessarily sufficient.

The productization process involves not only the ability to design a *product* (defined here to include services as well) but also the ability to produce the product. For a service firm, the ability to produce a product involves the firm's service delivery system—the mechanism through which services are provided to customers. For example, Domino's Pizza provides home-delivered pizza. Both the pizza and home delivery are aspects of the company's products. Similarly, although coffee is nominally the core product of Starbucks, the real product is the coffee experience provided by Starbucks' cafés. One service provided by Head Start agencies is education, which is provided to children in

the agencies' centers (as is true of traditional preschools), as well as to children and their families at home. The service and the delivery mechanism, together, constitute Head Start's education product.

Productization is not simply a task for relatively new or small companies; it faces large, well-established firms as well. Indeed, it can even face whole industries. For example, in the 1970s U.S. automobile manufacturers were unsuccessful in productizing their products to meet the changing needs of their market, including the growing need for reliable, fuel-efficient, economical automobiles. The same problem was faced by Xerox in the photocopying industry, U.S. Steel in specialty steels, and all U.S. television manufacturers. As a result, Japan emerged as a powerful competitor in markets that the Americans had once dominated.

The success of productization depends, to a very great extent, on success in defining the firm's market (that is, its customers and their needs). The greater the degree to which a firm understands the market's needs, the more likely that its productization process will be effective in satisfying those needs. Productization is the second key development task in building a successful organization.

**Acquire Resources.** The third major task of a developing organization is acquiring and developing the additional resources it needs for its present and anticipated future growth. A firm may have identified a market and created products but not have sufficient resources to compete effectively. For example, small competitors in the soft drink industry need to be low-cost producers. This requires high-speed bottling lines, which, at a cost of \$1 million-plus a line, the smaller firms simply cannot afford. In the nonprofit world, "capacity building" (having the funds needed to support ongoing operations) is a continuing challenge for many foundations, charities, and government-funded entities.

A firm's success in identifying a market and in productization creates increased demand for its products or services, or both. This, in turn, stretches the firm's resources very thin. The organization may suddenly find that it requires additional physical resources (space, equipment, and so on), financial resources, and human resources. The need for human resources, especially in management, will become particularly acute. At this stage of development, the firm's very success, ironically, creates a new set of problems.

The company must now become more adept at resource management, including the management of cash, inventories (if a manufacturing company), personnel, and so forth. It is at this stage that an entrepreneur must begin to think longer term about the company's future needs. Failure to do this can be costly. For example, one entrepreneur told how he kept purchasing equipment that became obsolete for the company's needs within six months because of the firm's rapid growth. Instead of purchasing a photocopying machine that would be adequate for the company's needs as it grew but was more than

currently required, for example, he purchased a machine that was able to meet only current needs. The result was that he spent much more on equipment than he would have if he had purchased machinery that was adequate for potential future needs. Similarly, another entrepreneur found himself with insufficient space six months after moving into new offices that he had thought would be adequate for five years, because the company grew more rapidly than he had anticipated. Another entrepreneur described how he had had to unexpectedly move his offices every five years because, after five years it always seemed that he had run out of space.

Another resource-related dilemma facing entrepreneurial companies involves the people they can hire. Often, entrepreneurs facing the need to hire people believe that they cannot afford to hire those with long-range potential to help them build their businesses; rather, they settle for those with lesser skills and abilities. Unfortunately, this may be a false economy. A few entrepreneurial firms do invest for the future and hire people who can grow with them. For example, one of the secrets to Starbucks' success was that they hired people who could help them build a billion-dollar-plus business from a very early stage. Starbucks' CEO, Howard Schultz, realized that human resources would be as much a key to Starbucks' long-term success as its now-famous coffee. This insight helped Starbucks grow during a fifteen-year period from a small entrepreneurial company in Seattle with two retail stores to an institution with more than six thousand stores and approximately \$6.4 billion in revenues by 2005.

**Develop Operational Systems.** To function effectively, a firm must not only produce a product or service but also administer basic day-to-day operations reasonably well. These operations include accounting, billing, collections, advertising, personnel recruiting and training, sales, research and development, production (or service delivery), information systems, transportation, and related systems.

The fourth task in building a successful organization is the development of the systems needed to facilitate these day-to-day operations—the operational systems. It is useful to think of a firm's operational systems as part of its "organizational plumbing." Just as plumbing is necessary for a house or building to function effectively, organizational plumbing is necessary for a business to function well. Thus operational systems make up part of an organization's infrastructure and are necessary to facilitate growth.

Typically, firms that are busy focusing on their markets and products tend to neglect the development of their operational systems. As a firm increases in size, however, an increasing amount of strain is put on such systems because the company tends to outgrow the organizational plumbing available to operate it. Following are several examples of firms in that predicament:

- In one electrical components distribution firm with more than \$200 million in annual revenues, salespeople were continually infuriated when they found that deliveries of products they had sold could not be made because the firm's inventory records were hopelessly incorrect.
- A medium-sized residential real estate firm with annual revenues of about \$10 million found that it required almost one year of effort and embarrassment to correct its accounting records after the firm's bookkeeper retired.
- A \$100 million consumer products manufacturer had to return certain materials to vendors because it had insufficient warehouse space to house the purchases (a fact no one noticed until the deliveries were at the door).
- A \$15 million industrial abrasives distributor found itself facing constant problems in keeping track of customer orders and in knowing what was in its inventory. The firm's inventory control system, which was fine when annual sales were \$3 to \$5 million, had simply become overloaded at the higher sales volume. One manager remarked that "nothing is ever stored around here where any intelligent person could reasonably expect to find it."
- A \$10 million service firm had no way of knowing whether the services it provided to customers were, in fact, profitable. Their financial management system did not provide this type of data, so they continued to offer their package of services and to hope for the best.
- A \$2 million nonprofit that prided itself on providing "the best" client service had no way of knowing whether this was, in fact, true. Complaints (and there were more than a few) came in, but there was no comprehensive system in place to track and address them.
- A \$100 million distributor of consumer products had a computer system that was so antiquated that few, if any, important reports were prepared accurately or on time. Whatever information was available had to be collected and analyzed manually.

These are just a few of the types of problems that firms encounter when they have not developed effective operational systems. The bottom line is that if these systems continue to remain underdeveloped, they can literally bring a business to a standstill. What is not well recognized by most entrepreneurs is that their company is competing not just in products and markets but in operational infrastructure as well. Wal-Mart is the classic example of how a small entrepreneurial company grew to be larger and more successful than its giant competitors. In the 1960s, Sears was the number-one retailer in the United States, and Kmart was the number-two retailer overall but the number-one discount retailer. Wal-Mart was a small company headquartered in Bentonville,

Arkansas. By analyzing his competition, Sam Walton understood that he could not compete head-to-head with Sears and Kmart, but he could develop some strengths for Wal-Mart (which might even become competitive advantages) by developing his company's logistics and information systems. Today, Wal-Mart has surpassed Sears and Kmart and has developed unsurpassed logistics and information systems, because Sam Walton understood that he was competing not just in products but in operational systems as well.

**Develop Management Systems.** The fifth task required to build a successful organization is developing the management systems needed for the long-term growth and development of the firm. There are four management systems: (1) planning, (2) organization structure, (3) management development, and (4) control or performance management systems. Management systems are another component of an organization's infrastructure, or organizational plumbing.

- *The planning system* consists of how the firm develops and implements its long-term plans for organizational development. It also includes operational planning, scheduling, budgeting, and contingency planning. A firm may do planning and have a strategy but still lack a planning system. The basic concepts and methods of strategic planning for entrepreneurially oriented, professionally managed firms are presented in Chapter Seven. Advanced concepts of strategic planning are described in Chapter Thirteen.
- *The organizational structure* of the firm determines how people are organized, who reports to whom, and how activities are coordinated. All firms have some organizational structure (formal or informal), but they do not necessarily have the correct structure for their needs. The concepts and methods for designing and evaluating organizational structure, required at different stages of growth, are presented in Chapter Eight.
- *The management development system* helps facilitate the planned development of the people needed to run the organization as it grows. Chapter Nine deals with management development and its role in making the transition from an entrepreneurship to a professionally managed firm.
- *Control or performance management systems* encompass the set of processes (budgeting, leadership, and goal setting) and mechanisms (performance appraisal) used to motivate employees to achieve organizational objectives. These systems include both formal control mechanisms, such as responsibility accounting, and informal processes, such as organizational leadership. Chapter Ten deals with organizational control systems.

Until the firm reaches a certain size (which tends to differ for each firm), it can typically operate without formal management systems. Planning tends to be done in the head of the entrepreneur, frequently on an ad hoc basis. The organizational structure, if it exists, tends to be informal, with ill-defined responsibilities that may well overlap several positions (or people). Management development tends to consist of on-the-job training, which basically means, “You’re on your own.” When control systems are used in such organizations, they tend to involve only the accounting system rather than a broader concept of management control.

The basic organizational “growing pain” that is a symptom of the need for more developed management systems is the decreasing ability of the original entrepreneur or senior executive to manage or control all that is happening. The organization simply becomes too large for senior managers to be personally involved in every aspect of it, and there is the gnawing feeling that things are out of control. This marks the need for developing or upgrading the firm’s management systems.

**Manage the Corporate Culture.** Just as all people have personalities, all organizations have a corporate personality or culture—a set of shared values, beliefs, and norms that govern the way people are expected to behave on a day-to-day basis. *Values* are what the organization believes to be important with respect to product quality, customer service, treatment of people, and so on. *Beliefs* are assumptions that people in the corporation hold about themselves as individuals and about the firm as an entity. *Norms* are the unwritten rules that guide day-to-day interactions and behavior, including language, dress, and humor.

Organizational culture can have a profound impact on the behavior of people, for better or for worse. Many companies, such as Starbucks, IBM, Hewlett-Packard, McDonald’s, Domino’s Pizza, Countrywide Financial Corporation, Disney, and Southwest Airlines have achieved greatness at least in part because of a strong corporate culture. Culture, then, is a critical factor in an enterprise’s successful development and performance. It functions as an informal control system, because it prescribes how people are supposed to behave.

Some managers believe that what is espoused as their corporate culture is actually the culture that affects people’s behavior. Unfortunately, this is often an illusion. For example, one rapidly growing entrepreneurship in a high-tech industry stated that its culture involved the production of high-quality products, concern for the quality of the working life of its employees, and encouragement of innovation. In reality, the firm’s culture was less positive. Its true concerns were to avoid conflict among its managers, set unrealistic performance expectations, avoid accountability, and overestimate

its performance capabilities. Moreover, the company saw itself as hard-driving and profit-oriented, when its real culture was sales-oriented, regardless of profitability.

Sophisticated managers understand that their companies compete as much with culture as with specific products and services. The CEO of a major New York Stock Exchange company once said that he could predict a division's organizational problems as soon as he had identified its culture. The sixth and final challenge in building a successful organization, then, is to manage corporate culture so that it supports the achievement of the firm's long-term goals. The nature and management of corporate culture are examined in Chapter Twelve.

## **THE PYRAMID OF ORGANIZATIONAL DEVELOPMENT**

The six tasks of organizational development just described are critical to a firm's successful functioning, not only individually but as an integrated system. They must harmonize and reinforce rather than conflict with one another. A firm's markets, products, resources, operational systems, management systems, and corporate culture must be an integrated whole. Further, the Pyramid of Organizational Development must support and be supported by the firm's business foundation. Stated differently, each variable in the pyramid affects and, in turn, is affected by each of the other variables (including the firm's business foundation). The management of an organization must learn to visualize this pyramid and evaluate their organization in terms of the extent to which its pyramid has been successfully designed and built.

### **Implications of the Pyramid of Organizational Development**

There are several important implications of the pyramid for management. First, the business foundation and the six key organizational development tasks make up different phases of the "business game." Just as the American game of football (the "business foundation") is composed of six key phases (rushing offense, passing offense, rushing defense, passing defense, and kicking and receiving), there are six key phases of the game of business—markets, products, resources, operational systems, management systems, and culture management. If an organization is weak in any phase of its game, it will experience a variety of growth-related problems (discussed in Chapter Three).

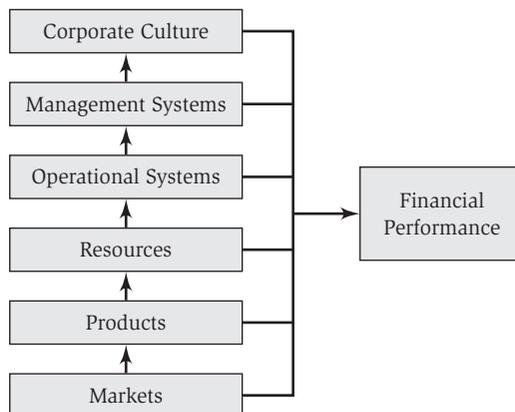
Another implication is that all organizations compete with other enterprises at all levels of the pyramid. For example, Wal-Mart and Kmart do not compete only with products but with their operational and management systems and

culture as well. Wal-Mart's logistics and information systems are a clear source of competitive advantage vis-à-vis Kmart and other discount retailers.

A third important implication is that, in the long term, the most sustainable competitive advantages are typically found at the top three levels of the pyramid (operational systems, management systems, and culture) rather than in products and markets. All markets can be entered by competitors, and all products can be copied or improved on over time (even pharmaceuticals can have generic versions), but the top three levels of the pyramid take time and money to develop and are difficult to copy. Even if an attempt is made by a competitor to emulate an enterprise's operational systems, management systems, and culture, their effort can be fruitless because of the unique aspects of each organization. We examine the strategic implications of the Pyramid of Organizational Development further in Chapters Seven and Thirteen.

### Research Support for the Pyramid

During the past few years, a growing body of research has provided empirical support for the validity of the Pyramid of Organizational Development framework.<sup>2</sup> This research has consistently indicated that there is a statistically significant relationship between the variables contained in the pyramid and the financial performance of companies. The six variables are hypothesized to account for as much as 90 percent of financial performance, with the remaining 10 percent attributable to exogenous factors. See Figure 1.2 for a graphic representation of these variables as drivers of financial results. Empirical research<sup>3</sup> to date has, in fact, indicated that as much as 80 percent of gross margin and 55 percent of EBIT (earnings before interest and taxes) is explained by the



**Figure 1.2.** Six Key Drivers of Financial Results

variables in the model. Additional research has indicated that the pyramid has a statistically significant relationship to ROI (return on investment).<sup>4</sup>

### The Pyramid as a Lens to Build and Evaluate Organizations

The pyramid framework can be used as a template for planning to build an organization and as a strategic lens through which to evaluate the strengths and limitations (or areas for improvement) of an existing enterprise. As such, it becomes the guide for planning to build a new business or to strengthen an existing business. This topic is addressed more fully in Chapters Seven and Thirteen, which deal with strategic planning and organizational development.

We must also recognize that although an organization should focus on the six levels in the pyramid, the emphasis on the components or subsystems of the pyramid must be somewhat different at different stages of organizational growth. Before we can explore this idea further, we must examine the different stages of growth through which entrepreneurial organizations develop. This topic is the focus of Chapter Two. First, however, we illustrate how the pyramid can be used to build a successful enterprise by describing the case of Starbucks Coffee Company.

### Starbucks Coffee Company: Successful Use of the Pyramid

Starbucks Coffee Company (Starbucks) is one of the truly great entrepreneurial success stories of the past two decades. The scope and speed of its success are reminiscent of Apple Computer, Nike, Microsoft, and Amgen.

Starbucks is a classic example of an organization that has been successful because it was effective in building the entire Pyramid of Organizational Development. It has achieved success as an organization through its development of the six key tasks of organizational development, not only each task individually but the effective development of the pyramid as a whole, as described in the sections that follow.<sup>5</sup>

**Identify the Business Foundation.** The original Starbucks began as a local roaster of coffee. In 1972, the company had two retail stores that sold coffee beans: one opened in 1971 near Seattle's Pike Place Market; the other, in 1972, opened in a shopping center across from the University of Washington's campus. This original Starbucks did not sell coffee beverages. It sold fresh-roasted coffee beans, teas, and spices. However, sometimes the individual behind the counter would brew some coffee and serve it in Dixie cups as samples.

Howard Schultz was not the original founder of Starbucks. He joined the company as director of retail operations and marketing in 1982. About one year later, Schultz visited Milan, Italy, to attend a trade show. While strolling

Milan's streets, he was struck by the ubiquity of the Italian coffee bars. He was drawn into them and realized that the coffee bars were an extension of people's homes and a part of the Italian culture. He saw the opportunity to develop something like what he had seen in Milan back in the United States. In April of 1984, Starbucks tested Schultz's idea by opening a coffee bar inside a Starbucks retail store, and it was an instant success. Despite the experiment's success, the original founders of Starbucks decided not to adapt it to Schultz's vision—an American version of an Italian coffee bar. Schultz left to create his own company called *Il Giornale*, which was founded in 1985. In August of 1987, Schultz went back to Starbucks with a buyout offer and a vision of taking the company nationally. *Il Giornale* acquired the assets and name "Starbucks" and changed its name to Starbucks Corporation.

In brief, Schultz's business concept for Starbucks was of a "national specialty retailer and café," or, as noted earlier, an American version of an Italian coffee bar. His mission was to build a national chain of coffee bars, and his strategy was based on Starbucks being able to provide superior quality in all aspects of product and operations: stores, coffee, signage, packaging, and customer experience.<sup>6</sup>

**Identify a Market and Develop a Product.** In terms of the Pyramid of Organizational Development, Schultz perceived the market not for coffee per se but for a different kind of "retail and café experience." Thus the product was not just coffee but the atmosphere and experience of the Starbucks store. The store itself was part of the product experience for the customer, not just the place where the product was purchased. It was part of a coffee-related experience. Schultz also realized that customer service was part of the overall product or experience to be delivered in a Starbucks store. As a result, Starbucks emphasized its unique brand of customer service from the beginning.

Neither coffee nor cafés were new products, but Starbucks had redefined them in some magical way. Schultz had, indeed, solved the first two challenges of building a successful enterprise: he had (1) identified a market and (2) developed a product. This, in turn, led to the rapid growth of Starbucks and created the next set of challenges: resources and operational systems.

**Acquire Resources and Develop Operational Systems.** Unlike many entrepreneurial companies, Starbucks paid a great deal of attention to the acquisition of resources and the development of operational systems. From the beginning, Schultz believed that he had a big opportunity, and he thought that Starbucks had the potential to become an enterprise with \$1 billion in sales.

He realized that if the company was going to fulfill its potential, he would need all the resources and systems required of a large company, including financial, physical (plant and equipment), technological, and human resources.

As he stated, “We could not have gotten where we are today if we had not had the commitment to build a national company with a national brand from the beginning. If you are going to build a 100-story building, you’ve got to build a foundation for 100 stories.”<sup>7</sup>

The first step was to raise money, and this became a continuing challenge, as Starbucks grew rapidly. Schultz spent considerable time finding investors, and without the “bucks” there would have been no Starbucks! The financial resources were used to hire people capable of building Starbucks into a national brand and a national company. This was not only true of a strong senior management team but also the acquisition of people at the operating levels, such as real estate, finance, and retail operations. Funds were also used to upgrade the company’s roasting plant, its logistics and manufacturing systems, and its overall day-to-day operating systems.

Starbucks’ investment in a strong operating team, as well as the related aspects of infrastructure, paid off for the company in many ways. The strong real estate team led the company to choose solid locations and avoid the real estate problems of other, similar organizations such as Boston Market and Koo Koo Roo. The company’s investment in developing strong financial systems led to a deeper understanding of store economics, and, in turn, a healthy business from a financial standpoint.

**Develop Management Systems.** In 1994, Howard Schultz and Orin Smith (then CFO and later COO of Starbucks) read the second edition of this book and invited Eric Flamholtz to visit Starbucks and assist the firm with its “growing pains.”<sup>8</sup> This, in turn, led to the development of a more sophisticated set of management systems for Starbucks, including a strategic planning system similar to that described in Chapter Seven and a revised organizational structure. In 1995, Starbucks also developed its management development and performance management (control) systems. Before that, there was a strategy and a plan but not a formal, integrated planning system. There was training for customer service personnel but no management development. In addition, there was an incentive system for people but no well-developed performance management system.

Taken together, planning, structure, management development, and control systems made up the overall management systems for Starbucks and completed the development (at least for this stage of the company’s growth) of the fifth level of the Pyramid of Organizational Development.

**Manage the Corporate Culture.** The highest level in the pyramid and the sixth task required to develop a successful enterprise involves culture management. From the beginning, Schultz and Starbucks had a clear idea that culture was

important in building a successful enterprise. In addition, Howard Schultz had a well-defined concept of the kind of organization he wanted to build. Accordingly, Schultz articulated five guiding principles that were intended to serve as the foundation for Starbucks' culture. Subsequently, a sixth guiding principle was added: "Embrace diversity as an essential component in the way we do business." Following is a list of all six guiding principles that make up the core of Starbucks' stated culture.

*Starbucks Corporation: Six Guiding Principles*

- Provide a great work environment and treat each other with respect and dignity.
- Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
- Develop enthusiastically satisfied customers all of the time.
- Contribute positively to our communities and our environment.
- Recognize that profitability is essential to our future success.
- Embrace diversity as an essential component in the way we do business.

In addition to the stated guiding principles of Starbucks, other facets of its culture are important as well. Schultz believed that the kind of organization that Starbucks was, and, in turn, the way it did business would become a source of sustainable competitive advantage. In effect, Schultz understood the role of culture as a building block of organizational success. Although he was not then familiar with the concept of "corporate culture" per se, he understood it intuitively. This led Starbucks to be concerned about the treatment of people employed by the firm. Ideally, he wanted everyone employed by Starbucks to behave like "owners." The notion was this: the way we treat our people will influence the way they treat our customers, and, in turn, our overall success. This led Starbucks to a number of different personnel practices, including providing full benefits for all people working more than twenty hours each week and providing opportunities for stock ownership. In other words, the company developed ways to manage its culture so that it would be embraced by its employees.

**Focus on the Pyramid as a Whole.** Starbucks is an illustration of a very successful entrepreneurial organization. The earlier discussion shows that Starbucks understood the need to develop all aspects of the pyramid and not merely focus on products and markets. Prior to 1994, the company had done an excellent job of developing five of the levels of the pyramid—everything except management systems. As we see later in this book, this is the classic

pattern of successful entrepreneurial companies. Beginning in 1994, at about \$175 million in sales, Starbucks began to develop the management systems that were required to facilitate its continued successful development. This “completed” the developmental work prescribed by the Pyramid of Organizational Development.

What happened to Starbucks? By the end of its fiscal year 2005, Starbucks had grown to more than \$6.4 billion in net revenues and more than 6,000 stores, including 4,200 company-owned stores. In addition, the company’s stock price increased substantially. From September 1, 1994, to September 1, 2006, the stock price increased (adjusted for splits) from \$1.78 to \$31.76. An investment of \$10,000 would have grown to \$178,302, for an increase of 1,683 percent. Clearly, successful development of the Pyramid of Organizational Development pays off.

### **Boston Market: A Contrast with Starbucks**

Boston Chicken (later renamed Boston Market) had people’s mouths watering for more than just their food. The company was supposed to become “The McDonald’s of the 90s.” It never happened. Instead, Boston Market filed for Chapter 11 reorganization under the bankruptcy law.

While Starbucks was earning quite a few bucks for its investors, Boston Market was costing its investors and franchisees lots of money.

What was different about the two companies? Whereas Starbucks successfully focused on all of the six key aspects of the Pyramid of Organizational Development, Boston Market did not. Boston Market did identify a market and had developed a good product, but the emphasis was on selling area franchises rather than truly building a solid business. In other words, the focus was on the bottom two layers of the pyramid versus the pyramid as a whole. Whereas Starbucks’ skilled real estate team identified good locations and negotiated sensible deals, Boston Market was perceived as overpaying for real estate. Whereas Starbucks’ financial people were analyzing costs of store build-outs and operations, Boston Market never got the economics of their stores under control. Their stores were expensive to build and operate, and they were not profitable. Although the restaurants were losing money, Boston Market was showing a profit for a while because of the heavy franchise fees charged. But the firm’s reported profitability was a mirage, which finally disappeared. In brief, Boston Market simply did not execute all of the six required tasks of organizational development effectively and ultimately paid the price.

This discussion is not intended to imply that Starbucks made no mistakes or was without problems—simply that it did a significantly better job in performing the required tasks to build a successful organization. Boston Market failed to focus on several of the key tasks of organizational development and went bankrupt.

## SUMMARY

This chapter presents a framework for understanding what makes an organization successful, effective, and profitable. The foundation of this framework is the firm's business foundation—the nature of the business the firm is in, its strategic mission, and core strategy.

Building on the foundation, an organization must focus on six areas if it is to succeed over the long term. These are (1) markets, (2) products or services, (3) resources, (4) operational systems, (5) management systems, and (6) corporate culture. For organizations to be successful, they must first identify their business foundation. Then they must deal not only with each of these six areas individually and in sequence but also with the six as parts of a whole. We use the image of a Pyramid of Organizational Development to describe this holistic approach.

Starbucks illustrates the power of developing a company in a way that is consistent with the pyramid. In the next chapter, we examine the different stages of growth and the different emphasis on each part of the pyramid that is required at each stage for a firm to be successful over the long term.



## Recognizing Growing Pains and Assessing the Need for Change

**W**hen an organization has not been fully successful in developing the internal systems it needs at a given stage of growth, it begins to experience growing pains. These growing pains are problems in and of themselves. However, they are also symptoms of a deeper, systemic problem: the need to transition to a different infrastructure to support the current and anticipated growth and size of the organization.

This chapter examines in detail the most common organizational growing pains, showing through examples how these growing pains emerge in real-life companies. It also presents a method of measuring organizational growing pains and interpreting the extent to which they signal the need for further organizational development. As part of this discussion we cite research showing that growing pains are statistically related to an organization's financial performance. The chapter then discusses the degree to which different sizes and types of businesses experience growing pains. Finally, it presents the case of Grange, Inc.—a company that faced many growing pains and worked to overcome them.

### THE NATURE OF GROWING PAINS

Growing pains are problems that occur as a result of inadequate organizational development in relation to business size and complexity. They are symptoms that something has gone wrong in the process of organizational development.

As such, they are a signal or alert about the need to make the transition from one stage of organizational development to the next. They are, as discussed later in this chapter, a set of leading indicators of future financial performance.

Ironically, growing pains are problems resulting from organizational success rather than failure. Nevertheless, they are simultaneously problems in and of themselves and signs or symptoms of an underlying systemic problem in the organization. The underlying problem is the failure of the organization's infrastructure to match or keep up with the size and complexity of the business. This means that the organization's resources, operational systems, management systems, and culture (the top four variables of the Pyramid of Organizational Development) have not been developed to the extent necessary to support the size, complexity, and growth of the enterprise.<sup>1</sup>

A simple rule of thumb is that when an organization doubles in size (measured either in terms of revenues, production volume, annual budget, or number of employees), it requires a different infrastructure. When this adjustment in infrastructure does not happen, organizational growing pains will increase in number and severity.

If the root causes of the organizational growing pains are not dealt with appropriately, even organizations that are successful undoubtedly will experience difficulties and possibly failure. To deal with growing pains, we must first be able to identify them and assess their severity.

## **THE TEN MOST COMMON ORGANIZATIONAL GROWING PAINS**

The ten most common (or classic) organizational growing pains are listed here:

1. People feel that there are not enough hours in the day.
2. People spend too much time "putting out fires."
3. People are not aware of what other people are doing.
4. People lack understanding about where the firm is headed.
5. There are not enough good managers.
6. People feel that "I have to do it myself if I want to get it done correctly."
7. Most people feel that meetings are a waste of time.
8. When plans are made, there is very little follow-up, so things just don't get done.
9. Some people feel insecure about their place in the firm.
10. The firm continues to grow in sales, but not in profits.

Each of these growing pains is described in the pages that follow.

*People feel that there are not enough hours in the day.* One of the most common organizational growing pains is the complaint that there is never enough time. Employees feel that they could work twenty-four hours per day, seven days a week, and still not have sufficient time to get everything done. They begin to complain about overload and excessive stress. Both individuals and departments feel that they are always trying to catch up but never succeeding. The more work they do, the more there seems to be, resulting in a never-ending cycle. People feel as if they are on a treadmill.

The effects of these feelings can be far-reaching. First, employees' belief that they are being needlessly overworked may bring on morale problems. Complaints may increase. Second, employees may begin to experience physical illnesses brought on by excessive stress. These psychological and physical problems may lead to increased absenteeism, which can decrease the company's productivity. Finally, employees may simply decide that they can no longer operate under these conditions and may leave the organization. This will result in significant turnover and replacement costs related to recruiting, selecting, and training new people.

When many employees feel that there is not enough time in the day, usually no one is suffering more from this feeling than the company's founding entrepreneur. The entrepreneur, feeling ultimately responsible for the firm's success, may work sixteen hours a day, seven days a week in an effort to keep the company operating effectively and help it grow. As the organization grows, the entrepreneur begins to notice that he or she no longer can exercise complete control over its functioning. This realization can result in a great deal of personal stress. We see examples of this in the cases of Metro Realty and Tempo Products in Chapters Five and Six.

The presence of this growing pain can suggest that the firm lacks or has an underdeveloped planning system, that there is a lack of a formal structure (in which roles and responsibilities are clearly defined), or that individuals do not understand how to effectively manage their time.

*People spend too much time "putting out fires."* A second common growing pain shows itself in excessive time spent dealing with short-term crises. This problem usually results from a lack of long-range planning, and, typically, the absence of a strategic plan. It can also result from the tendency to hold onto a culture that rewards fire fighters, rather than planners. Individual employees and the organization as a whole live from day to day, never knowing what to expect. The result may be a loss of organizational productivity, effectiveness, and efficiency.

Examples of the putting out fires problem are easy to find. In one \$10 million service firm, a lack of planning caused orders to be needlessly rushed, resulting in excessive pressure on employees. Drivers had to be hired on weekends and evenings to deliver orders, some of which were already overdue. Similarly, at

Maxicare the “surprises” that were encountered after acquisitions led to an almost endless number of fires.

In other companies, which we discuss in more detail later, lack of planning produced other short-term crises. At Metro Realty, for example, it resulted in shortages of salespeople. Because of these shortages, Metro was forced to hire new people and put them to work almost immediately, sometimes without adequate training. This, in turn, contributed to short-term productivity problems because the new people did not possess the skills necessary to be good salespeople. Similarly, at Tempo Products the lack of personnel planning also created problems but for different reasons. There, personnel were hired to take up the slack when business was good. Once the crisis was over, the company found it had a number of people it simply did not know what to do with.

Fires were so prevalent at one \$50 million manufacturing company that managers began to refer to themselves as fire fighters, and senior management rewarded middle management for their skill in handling crises. When it became apparent that managers who had been effective in “fire prevention” were being ignored, some of them became “arsonists” to get senior management’s attention. The arsonists set fires that could be fought as a way of showing that they were contributing to the organization.

*Many people are not aware of what others are doing.* Another symptom of organizational growing pains is that many people are increasingly unaware of the exact nature of their jobs and how these jobs relate to those of others. This creates a situation in which people and departments do whatever they want to do and say that the remaining tasks are “not our responsibility.” Constant bickering between people and departments over responsibility may ensue. The organization may become a group of isolated and sometimes warring factions.

These problems typically result from the lack of an organization chart and precise role and responsibility definitions, as well as effective team building. Relationships between people and between departments, as well as individual responsibilities, may be unclear. As becomes clear in the cases of Metro Realty and Tempo Products, people can become frustrated by this ambiguity and begin creating their own definitions of their roles, which may not always be in the best interests of the firm. The president of Metro Realty vividly described this phenomenon when he said, “We were a collection of little offices working toward our goals without consideration for the good of the company.”

The isolation of departments from one another may result in duplication of effort or in tasks that remain incomplete because they are “someone else’s responsibility.” Constant arguments between departments may also occur over territory and organizational resources. We see in Chapter Six that Tempo Products suffered from the effects of the need to define and protect territory as well. This was also a problem at a large technology company where there were eighteen different divisions, each focusing on its own product line to the

exclusion of the overall corporate goals. Even as product lines evolved and began to overlap, the salesforce continued to focus only on its own line to the exclusion of others. This resulted in some customers being called on by three or more salespeople, each representing a different product group and sometimes even offering similar services for different prices. In essence, the company competed against itself. Ultimately, the company lost control of its own destiny and was acquired by one of its competitors.

*People lack understanding about where the firm is headed.* Another typical growing pain is a widespread lack of understanding of where the firm is headed. Employees may complain that “the company has no identity” and either blame upper management for not providing enough information about the company’s future direction or, worse, believe that not even upper management knows what that direction will be. This can result from the inability of senior management to agree about the company’s future direction (as we see in the case study of Falk Corporation presented in Chapter Sixteen) or can be due to a communication breakdown.

When insufficient communication is combined with rapid changes, as is often the case in growing firms, employees may begin to feel anxious.<sup>2</sup> To relieve this anxiety, they may either create their own networks for obtaining the desired information or come to believe that they know the company’s direction, even though management has not actually communicated this information. Both these strategies were used by Tempo Products’ employees. Employees’ speculations, as well as real information obtained from people who were close to senior management, circulated freely on the company’s grapevine. Rumors were rampant, but in fact very few people really knew why certain changes were being made. Hence, employees experienced a significant amount of anxiety. If anxiety increases to the point where it becomes unbearable, employees may begin leaving the firm. It should be noted that turnover of this kind can be very costly to a firm.<sup>3</sup>

The primary factor underlying this growing pain tends to be inadequate strategic planning. Either the firm has an inadequate or underdeveloped planning process or plans that are made are not effectively communicated throughout the organization.

*There are not enough good managers.* Although a firm may have a significant number of people who hold the title of “manager,” it may not have many good managers. Managers may complain that they have responsibility but no authority. Employees may complain about the lack of direction or feedback that their managers provide. The organization may notice that some of its divisions or departments have significantly higher or lower productivity than others. It may also be plagued by managers who constantly complain that they do not have time to complete their administrative responsibilities because

they are too busy increasing business. When any or all of these events occur, something is wrong with the management function of the organization.

The problem may be that the company has promoted successful doers (salespeople, office workers, and so on) to the role of manager, assuming that they will also be successful in this role. These two roles require significantly different skills, however. Thus without proper training many doers fail in the manager's role. Their tendency to continue "doing" will show itself in poor delegation skills and poor coordination of the activities of others. Direct reports may complain that they do not know what they are supposed to do.

Problems like these suggest that the company has not adequately defined managers' roles or is not providing sufficient training to ensure that those in these roles have the skills needed to effectively fulfill them. If there are unclear role descriptions, those in management positions may not understand what they are expected to do. In an effort to "do something," these individuals may revert to re-creating their old roles—focusing too much attention on doing work, rather than managing work. If training exists, the firm may be relying too much on on-the-job training rather than on formal management development programs. In some companies, this on-the-job training is carried to such an extreme that companies literally or figuratively walk the new manager to his or her office and say, "Here's your department. Run it."

Management problems may also result from real or perceived organizational constraints that restrict a manager's authority. In the case of Tempo Products, we show how the perception that only top management could make decisions greatly affected lower-level managers' effectiveness. One person at this firm described the managers as "people with no real responsibility." The feeling that only upper management has decision-making responsibility is common in firms making the transition to professional management. It is a relic from the days when the founding entrepreneur made all the firm's decisions.

*People feel that "I have to do it myself if I want to get it done correctly."* Increasingly, as people become frustrated by the difficulty of getting things done in an organization, they come to feel that to get something done, they have to do it themselves. This symptom, like lack of coordination, is caused by a lack of clearly defined roles, responsibilities, and linkages between and among roles. It may also result from a lack of resources or the inability (or unwillingness) of managers to relinquish control over results to others.

As was discussed previously, when roles and responsibilities are not clearly defined, individuals or departments tend to act on their own because they do not know whose responsibility a given task is. They may also do the task themselves to avoid confrontation, because the person or department to whom they are trying to delegate a responsibility may refuse it.

Operating under this philosophy, departments become isolated from one another, and teamwork becomes minimal. Each part of the company "does

its own thing” without considering the good of the whole. Communication between management and lower levels of the organization and between departments may be minimal because the organization has no formal system through which information can be channeled. We see how the lack of coordination between areas can lead to productivity problems and inefficiencies in the cases of Grange, Inc., Metro Realty, and Tempo Products.

*Most people feel that meetings are a waste of time.* Recognizing that there is a need for better coordination and communication, the growing organization may begin to hold meetings. Unfortunately, at many firms these meetings are, at best, nothing more than discussions among people. They have no planned agendas, and often they have no designated leader. Participants may be allowed to take cell phone calls, use their computers, check e-mail via computer or PDA, hold side conversations, and focus on many things other than the content of the meeting. Meetings become a free-for-all, tend to drag on interminably, and seldom result in decisions. The same agenda items appear again and again. As a result, people feel frustrated and conclude that “our meetings are a waste of time.”

The impact of ineffective meetings can be significant. For example, after five full days of work, one high-tech company’s senior management team had yet to finalize its strategic plan. Why? Each day of meetings was constantly interrupted by “today’s crisis,” which took one or more members of the team (including the CEO) out of the meeting for an extended period of time. Executives continually checked e-mail on their BlackBerries, resulting in a lack of focus on the discussions taking place. When each executive “tuned back in” to the discussion, the rest of the group had to spend time helping him or her catch up. Each executive had a specific agenda of items that needed to be discussed and, instead of listening to and staying focused on the topic that was on the table, decided to share whatever was on his or her mind. As a result, the discussion jumped from topic to topic, with only limited resolution of issues. After five days of meetings, over a period of three months, the team decided that the plan was good enough, simply because they didn’t have the time to finish it.

Other complaints about meetings involve lack of follow-up on decisions that are made. Some companies schedule yearly or monthly planning meetings during which goals are set for individual employees, departments, and the company as a whole. These sessions are a waste of time if people ignore the goals that have been set or fail to monitor their progress toward these goals. As we see in Metro Realty’s case, the budgeting process suffered from this condition. In a frustrating “yearly exercise,” managers met and set goals, then met again the following year with no idea of whether they had achieved the previous year’s goals.

Although the problems listed result from too many meetings or meetings that are poorly managed, at the other extreme are companies where meetings are seldom held. In these situations, there is limited communication and coordination. As a result, the company frequently suffers from productivity problems, including duplication of effort.

*When plans are made, there is very little follow-up, so things just don't get done.* Another sign of an entrepreneurship with growing pains is a lack of follow-up after plans are made. Recognizing that the need for planning is greater than in the past, an entrepreneur may introduce a planning process. People go through the motions of preparing business plans, but the things that were planned just do not get done. In one amazing case, there was no follow-up simply because the plan, after being prepared, sat in a drawer for the entire year until the next year's planning retreat. When asked about the plan, one senior manager stated: "Oh that. It's in my desk. I never look at it."

In some cases there is no follow-up because the company has not yet developed adequate systems (that is, control systems) to monitor progress against goals. For example, many firms desire to monitor financial goals but have not developed an accounting system that can provide the information needed to do so. Metro Realty suffered from this deficiency.

In other cases, follow-up does not occur because personnel have not received proper training in setting, monitoring, and evaluating goals. They set goals that cannot be achieved or cannot be measured, or they do not know how to evaluate and provide useful feedback on goal achievement. These problems tend to appear most often in the performance appraisal process, a topic discussed further in Chapters Five and Six. Chapter Ten deals with how to design and effectively use control and performance management systems.

*Some people feel insecure about their place in the firm.* As a consequence of other organizational growing pains, employees begin to feel insecure about their places in the firm. In some cases, the entrepreneur has become anxious about problems facing the organization and has therefore hired a "heavy-weight" manager from outside. This action may have been accompanied by the termination of one or more current managers. Employees feel anxious, partly because they do not understand the reasons for these and other changes. When anxiety becomes too high, it may result in morale problems or excessive turnover.

Employees may also become insecure because they are unable to see the value of their position to the firm. This occurs when roles and responsibilities are not clearly defined and terminations are also occurring. Employees begin to wonder whether they will be the next to get the axe. In an attempt to protect themselves, they keep their activities secret and do not make waves. This results in isolation and a decrease in teamwork.

Entire departments may come to suffer from the need to remain isolated in order to protect themselves from being eliminated. This can lead to a certain amount of schizophrenia among employees. They begin to ask, "Am I loyal to my department or to the organization at large?" This happened at Tempo Products, as we see in Chapter Six. In another Stage IV firm, one employee expressed her sense of anxiety this way: "This company could give me a trip around the world for free and I would think they were trying to get rid of me." In this same organization, people indicated that they were afraid they would be fired if they said anything controversial. However, when pressed about the extent to which people had been terminated, no one could identify a specific case. In effect, the culture of the organization had become one that promoted anxiety and fear. It also created a situation in which people spent more time covering their own vested interests than working toward achieving company goals.

*The firm continues to grow in sales, but not in profits.* If all the other growing pains are permitted to exist, one final symptom may emerge. In some instances, sales continue to increase while profits remain flat, so that the company is succeeding only in increasing its workload. In the worst cases, sales increase while overall profits actually decline. As we see in the chapters that follow, companies may begin to lose money without having any idea why. The business loss can be quite significant, even though sales are up. There are many examples of entrepreneurial companies that experienced this problem, including Apple Computer, Maxicare, People Express, and Osborne Computer.

In a significant number of companies, the decline in profits may be the result of an underlying philosophy that stresses sales. People in such companies may say, "If sales are good, then profit will also be good," or "Profit will take care of itself." Profit in these companies is not an explicit goal but merely whatever remains after expenses.

In sales-oriented companies, people often become accustomed to spending whatever they need to in order to make a sale or promote the organization. For example, at Tempo Products, employees believed that it was important to the company's image to always "go first class." They made no effort to control costs, because they believed that no matter what they did, the organization would always be profitable. Organizations may also suffer because of systems that reward employees for achieving sales goals rather than profit goals (examples of these problems are given in Chapters Five and Six).

For nonprofits, this growing pain can be restated as, "Our administrative costs have increased more rapidly than our funding (budget)." This growing pain can result from inadequate focus on fund acquisition (for example, in some nonprofits only a very few people are responsible for fundraising), from a belief that sources will continue to provide the same level of funding year after year, or from underdeveloped budgeting processes that do not provide

the information needed to track administrative costs. The result is a lack of balance between “what we have” and “what we need” to support ongoing operations and can, at times, lead to the nonprofit’s demise.

## MEASURING ORGANIZATIONAL GROWING PAINS

Growing pains are not just binary, meaning they exist or not. There are degrees of severity of growing pains.

To assist the management of an entrepreneurial company in measuring the organization’s growing pains, we have developed the Survey of Organizational Growing Pains, shown in Exhibit 3.1.<sup>4</sup>

This questionnaire instrument presents ten organizational growing pains that have been identified in a wide variety of entrepreneurial companies with annual sales revenues ranging from less than \$1 million to over \$1 billion. Responses to the survey are entered on a Likert-type five-point scale, with descriptions ranging from “to a very great extent” to “to a very slight extent.”<sup>5</sup> By placing check marks in the appropriate columns, the respondent indicates the extent to which he or she feels each of the ten growing pains characterizes the company.

### Scoring the Survey

Once the survey has been completed, the number of check marks in each column is totaled and recorded on line 11. Each item on line 11 is then multiplied by the corresponding weight on line 12, and the total is recorded on line 13. For example, Exhibit 3.1 shows four check marks in column B. Accordingly, we multiply 4 by the weight of 4 and record the result, 16, on line 13 of column B.

The next step is to determine the sum of the numbers on line 13. This total represents the organization’s growing pains score. It can range from 10, which is the lowest possible or most favorable score, to 50, which is the highest possible or most unfavorable score.

### Interpreting the Scores

Drawing on our research concerning the degree of seriousness of problems indicated by different growing pains scores, we have worked out the color-coding scheme shown in Table 3.1.

More detailed interpretation of score ranges is as follows:

- A *green score* represents a fairly healthy organization. It suggests that everything is probably functioning in a manner satisfactory for the organization at its current stage of development.