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Managing your organization by the evidence

Article at a glance

Executives, in their search for ways to make organizations function more successfully, frequently adopt simplistic solutions.

A new analysis of more than 230 global businesses shows that combinations of carefully selected actions can be far more effective than one-dimensional interventions.

Although organizations tend to perform better when they use specific practices to make employees accountable, to set goals and priorities, and to establish a performance culture, they achieve the best results by undertaking all three simultaneously.

Companies with a lot of organizational baggage—the legacy, perhaps, of a strong culture or leadership style—may need to modify this “base case.”

McKinsey&Company

Managing your **organization** by the evidence

An organization is much more likely to improve its current performance and underlying health by using a combination of complementary practices rather than any one of them alone, according to new McKinsey research.

Keith Leslie, Mark A. Loch, and William Schaninger

When it comes to simple remedies, few are more seductive than those claiming to help companies create a healthy organization. One-dimensional messages about how to achieve sustainable organizational excellence remain in circulation even though most CEOs and other senior executives instinctively know that any large company's people, processes, teams, and control systems require artful handling. The head of one North American auto manufacturer, for example, asserted in a recent edition of the *Financial Times* that a new culture allowing employees to speak out "boldly" would drive the company's future success. In the same edition, a major investor in a fast-food business insisted that direct equity compensation for senior managers was the missing key to organizational efficiency.

Without hard data, bold claims are hard to resist. But new McKinsey analysis of more than 230 businesses around the world provides evidence for a much more subtle picture. This research, aggregating results from the past four years, shows that strong organizational performance is really fueled not by isolated interventions but by a combination of three or four carefully selected complementary ones—what we call management "practices." Executives can use a wide range of them to improve the organizational performance of a company—in other words, its ability to unite around common goals, to execute efficiently, and to renew itself over

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the longer term by, for example, refreshing product lines, replacing people, and upgrading capabilities.

Most executives rely on their experience and personal knowledge of, at most, two or three companies to shape their mantras and determine which organizational levers to pull. Our analysis provides a much wider base of knowledge for decision making. Three main conclusions stand out from our data. The first is that executives should eschew simplistic organizational solutions: when applied in isolation by the companies in our database, popular techniques such as management incentives and key performance indicators (KPIs) were strikingly ineffective. Second, high-performing companies must have a basic proficiency in all of the available practices; a conspicuous weakness in any of them drags down the overall result.

The third finding—and our main contention—is that managers should concentrate most of their energy on a small number of practices that, introduced together, typically produces the best results, according to our 115,000-plus respondents (see sidebar "The data behind the findings," on the next spread). Doing more doesn't add much value and involves disproportionate, not to mention wasted, effort.

Which combinations of practices are most effective at creating high levels of near-term organizational performance and longer-term organizational health—meaning the ability to generate sustained performance year after year? Careful selection is crucial because the complementarity among practices (the additional impact they have when applied together) is what creates organizational excellence.

A look at prevailing wisdom

Advice from business commentators, elder statesmen, consultants, and other experts on organizational performance often falls into either of two traps. Some of these authorities fail to give the full picture because they assume that companies already have a number of complementary building blocks in place and therefore systematically overestimate the impact of a single practice. Others have a preference—as external observers, consultants, and new appointees typically do—for one big, visible intervention they regard as more effective than a combination of less dramatic initiatives.

Unfortunately, a single practice is generally inspired and implemented in isolation. Those who champion that approach ignore not only the impact of concurrent organizational practices—successful and unsuccessful alike—but also the complementarities generated by the other practices a company could implement simultaneously.

Our research has used well over one hundred thousand questionnaires to track the practices that a company can use to improve its performance—from increasing the leadership's effectiveness and ability in charting a clear course to motivating employees and giving them the ability to innovate. By studying the impact of specific practices on specific organizational outcomes, we show that several popular remedies do not live up to their reputations.

- The carrots and sticks of incentives appear to be the least effective of the four options commonly used to motivate and encourage employees to perform well and stay with a company.

- Applied in isolation, KPIs and similar control mechanisms (such as performance contracts) are among the least satisfactory options for improving accountability.

- Relying on a detailed strategy and plan is far from the most fruitful way to set a company's direction.

- Command-and-control leadership—the still-popular art of telling people what to do and then checking up on them to see that they did it—is among the least effective ways to direct the efforts of an organization's people.

Ignore any practice at your peril

An exhaustive analysis of our data shows that companies cannot afford to neglect *any* of the 34 practices listed in the sidebar "A wide range of management practices," on page 70: achieving at least a minimum standard of proficiency across the whole range is vital for an organization's overall performance. What's more, lack of success in any two or three practices makes it almost impossible for a company to do well. Consequence management (to give carrots and sticks their polite name) is not, by itself, a particularly effective way to make employees accountable, but without a minimum level of proficiency in it a company has little chance of performing well overall.

Organizations don't need superior abilities in all of these practices—far from it—but a failure to achieve competence in any one of them drags down the performance of the whole. An analysis of our database confirms the intuition of many managers: little can be gained by going beyond basic competence in several practice areas (incentives to motivate employees, for example). The good news is that management's task is simpler because companies don't have to be good at everything.

Some organizational choices are clearly superior

One combination of practices increases the overall effectiveness of organizations more than others do. Indeed, it proved more effective for over half of the companies in our database, so we regard it as the "base case" (that is, the default solution) for any organization seeking to become more

The data behind the findings

The data supporting this article's conclusions come from McKinsey's Performance Leadership Survey, an in-depth questionnaire explicitly designed to explore an organization's effectiveness. Set up in 2002, the database contains information from almost 400 discrete business units of 231 global businesses in all major regions and industry sectors. More than 115,000 individual managers and employees have participated.

Our survey captures two distinct but related aspects of performance—outcomes and practices. The questions about outcomes probe a company's effectiveness at managing nine organizational elements: direction, leadership, environment and values, accountability, coordination and control, capabilities, motivation, external orientation, and innovation. The questions about practices help to identify the way companies try to achieve these outcomes.

To take accountability as an example, the outcome measured is the extent to which an organization's people know what they are accountable for doing. The practices creating a sense of accountability range from the design of structures and roles to performance contracts to "consequence systems" (rewards and penalties) to implicit agreements. Any combination of these can in theory achieve the desired outcome.

As for capabilities, the effective outcome is an organization with the right skills and talent to support its strategy and competitive advantage. To that end, a company can use a variety of practices—hiring exclusively at entry level and nurturing talent internally, hiring experienced people, or resorting to contractual and temporary solutions.

Regardless of a company's choice, the definition of an effective outcome remains the same.

Our analysis of the data focused on the relationship between these variables—outcomes and practices. Two questions particularly engaged our attention. The first was determining the likelihood that a particular practice will deliver a distinctive outcome (meaning that the company using it ranks in the top 25 percent of the database). The other was to find out which combinations of distinctive practices have the greatest chance of generating distinctive outcomes. We found many examples of practices that, by themselves, had limited value but become highly effective when paired with a complementary practice; the combination of clear roles and performance contracts is a good example.

We tested this article's high-level conclusions for robustness across industries, geographies, organizational size, and so forth. None of these conclusions have only marginal or partial support from the data.

healthy. Yet nearly half of all companies have good reason to feel that a different approach would work better for them. They should be cautioned, nonetheless: no other combination of practices has as clear a record of success as the base case does.

What is this proven combination of practices? To arrive at it, you must extrapolate backward from the outcomes you seek. Academic literature, our own experience, and intuition all point to accountability, clear direction setting, and a strong culture as the main foundations of a high-performing company. These outcomes underpin high levels of organizational performance.

The McKinsey research unambiguously identifies the best practices for achieving these outcomes. Senior executives must provide for clear roles within a structure matched to the needs of the business (accountability), articulate a compelling vision of the future (direction), and develop an environment that encourages openness, trust, and challenge (culture). Each of these practices, the data tell us, works best in relation to a specific outcome, but applied in combination they produce much more dramatic results, for they have a mutually reinforcing dynamic. Increasing the amount of effort behind any one practice increases the likelihood of achieving not only its target outcome but also the other target outcomes, thus making organizations more effective overall.

For most people, the way these three practices—clear roles, an inspiring vision, and an open and trusting culture—interact to create complementarities is intuitively clear. Employees perform well when they are working toward a future that attracts them, know when they can operate freely, and are encouraged to improve constantly.[1] Our research supports such intuitions not only because the survey respondents linked the base case to overall organizational effectiveness but also because companies that apply the base case outperform the others in revenues and margins. In our view, the correlation between the base case and superior performance is not an accident, and causality probably operates only in one direction: a better organizational design begets higher performance. Moreover, the link to financial performance is empirically evident as well, at least anecdotally. An analysis of the organizational effectiveness of different production facilities owned by the same global energy group, for instance, showed that improved organizational performance correlates to improved financial performance (exhibit, on the next spread). For a facility of typical size and with typical margins, better organizational performance correlated to a financial improvement worth $25 million to $30 million.

[1] For a full discussion of the importance of complementarities in organizational design, see John Roberts, *The Modern Firm: Organizational Design for Performance and Growth,* Oxford: Oxford University Press, 2004.

A wide range of management practices

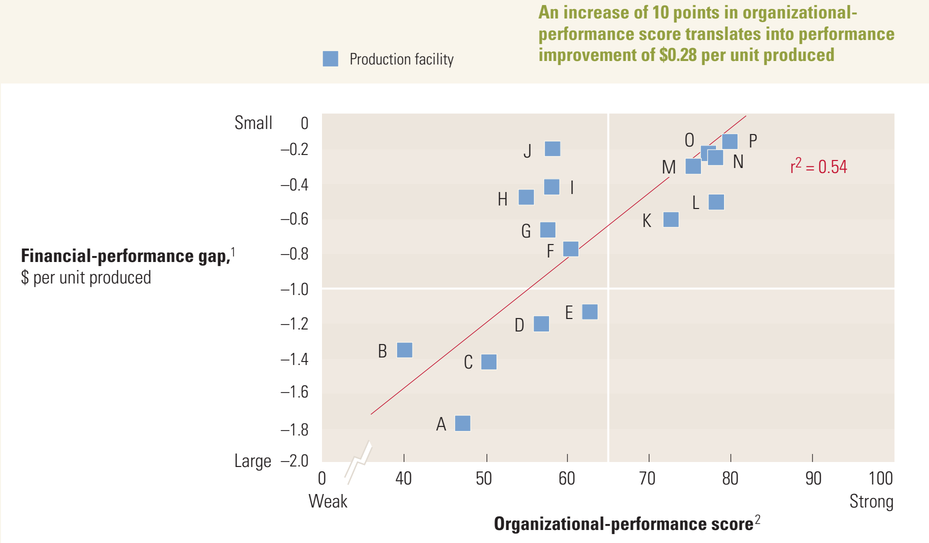
Outcome	Type of practice	Brief description
Direction (where company is heading)	• Visionary • Directive/strategic • Engagement	• Top down, attractive, personally meaningful • Top-down specifics for reaching end state • Driven by input from below
Leadership	• Community • Command and control • Patriarchal	• Hands off, delegating, empowering • Hands on, highly concentrated authority • Strong but caring
Environment, values	• Open, trusting • Competitive • Operational/disciplined • Entrepreneurial/creative	• Collaboration, transparency • Competition, high intensity • Process-driven efficiency, consistency • Innovation, initiative, creativity encouraged
Accountability	• Structure, role design • Performance contracts • Consequence mangement • Personal obligation	• Formal structures creating role clarity • Explicitly stated and accepted • Rewards, penalties • Implicit agreement on what's involved
Coordination, control (of performance, risk)	• People based • Financial • Operational • Values, professional standards	• Management via HR systems • Management of financial performance • Focus on KPIs[1] and metrics, targets • Management of actions through ethics, boundaries
Capabilities	• Process based • Internally developed • Acquired • Rented/outsourced	• Embedded knowledge, manuals • Organic, focus on training • Skills brought in from outside • Skills borrowed—eg, consultants
Motivation	• Leaders • Values • Opportunities • Incentives	• Charisma • Company culture • Job design, autonomy • Financial rewards, recognition
External orientation	• Customer/channel • Competitor/market • Business/partner • Government/community	• Cultivation of relationships with end users • Focus on rivals, controlling market share • Business collaboration between two parties • Aligned with political/regulatory powers
Innovation	• External sourcing • Top down • Bottom up • Cross-pollination	• Renewal from outside company • Ideas, change generated by top management • Ideas, change generated by each business unit, department • Ideas, change from knowledge sharing across organization

[1] Key performance indicators.

EXHIBIT

High returns on organizational performance

Correlation of organizational performance with financial-performance gap for global energy company



r^2 is the proportion of variance explained by a regression.
[1]Distance between actual and benchmarked performance.
[2]As measured by each production facility's average score for 9 outcomes.

Accountability

Many executives, we find, struggle to design structures, create reporting relationships, and develop evaluation systems that make people accountable—in other words, that require them to take responsibility for the results of the business. Our database suggests that companies seeking to improve in this area are much more likely to succeed if they concentrate on giving individuals clear roles rather than resorting to other options, such as consequence management. Our own experience of working with companies confirms this point. The regional directors of a multinational building-materials group, for example, took greater individual responsibility for their regions' performance when the company adopted role descriptions defining their autonomy in customer and operational decisions but standardizing all back-office and control processes. New KPIs, reporting mechanisms, and rewards were only introduced a year later.

Direction

Every company must give its employees a sense of direction and enable management to make the right trade-offs. What's the best way to achieve these goals? Our data reveal that executives who set broad, stretching aspirations that are meaningful to their employees have a better chance of achieving the outcome they want than do executives who resort to conventional, dominant, or detailed top-down leadership. We know one

European mobile-phone operator, for example, whose new high-level corporate vision and operating strategy helped its middle managers identify priorities for improving its operating, customer service, and cost performance rapidly. By contrast, a rival's more detailed transformation program struggled to get traction with the key implementers.

A performance culture

Our research offers statistical proof that the best way to promote high-performance behavior in organizations is to emphasize openness and trust among employees. A manufacturing company we know, for example, stresses experimentation and ad hoc project work, which lead to higher levels of productivity and innovation than rivals achieve with better-funded but highly structured programs. Our data and experience show that the typical approaches companies take to improve their performance—internal competition or process-driven efficiency and consistency—are a lot less effective than openness and trust.

The other half

Our view that at least 50 percent of all companies should apply the base case is founded on data showing that 23 percent of them already apply two out of the three practices effectively and that 40 percent apply one. Furthermore, we reckon that 25 percent of all companies could redesign themselves from scratch after a dramatic organizational event such as an acquisition or a radical strategic or leadership change. But how can we identify the 50 percent of companies that would not be best off applying the base case? And what combinations would probably work most successfully for them?

The data do not support the answers you might have expected. There is no correlation, for example, between successful organizational designs and contextual differences among industries or the workers they employ. The base case is equally successful in, for instance, manufacturing industries, dominated by equipment and labor; financial services, dominated by capital and systems; and pharmaceutical companies, dominated by knowledge and innovation. This is not to say that management should ignore the differences among industries or types of work, but the data do not tell us that the base case is less effective in any one of them. Differences in the way companies should apply it in such contexts may well emerge through further research, but for the moment we must look elsewhere.

What we can safely say now is that contextual differences in organizational culture or strategy are more important than contextual differences among industries. A company's organizational culture or strategy may mean that excessive transitional costs or the uncertainties of cultural change would make it unwise to implement the base case.

To choose the right combination of practices, companies should test their emerging options against the base case and then look for any obstacles that their organizational, leadership, and strategic context might put in its way. They will find that they don't have an infinite number of options; they must identify the right combination of two to four complementary practices that could improve their performance significantly given their particular context. The base case is so powerful in part because it builds on preferred patterns of effective management behavior and in part because of the complementarities across its three major practices. Alternatives to it must, at a minimum, show the same high degree of complementarity across the practices they emphasize.

Since there will be no one-size-fits-all solution, it may be helpful to ponder the choices that some companies have made. Consider the case of the investment bank that, like its peers, uses financial incentives heavily. Even if they are not especially effective motivators by themselves, they can have a dynamic impact as part of a set of organizational interventions including efforts to develop a top-down vision of the future and a competitive, intense performance culture. This bank's organizational and industry heritage therefore called for a large element of individual measurement and reward.

Likewise, in the petroleum industry each of the supermajors cherishes its own deep-rooted patterns of behavior and routines. ExxonMobil, for instance, has many more rigorously applied standard operating procedures than do BP, Chevron, Royal Dutch Shell, and Total. Standardization clearly has advantages—the company claims to "get things 90 percent right 100 percent of the time"—but the executives of ExxonMobil would have difficulty adopting practices that run counter to its current approach, which is ingrained throughout its management systems. Standardized operations mean that the base-case option is not available, at least not without high transitional costs in a global company with hard-to-change routines and values. If ExxonMobil wanted to make its employees more motivated, it might do better by giving them new roles or project opportunities when they show that they can improve its performance while staying within the rules of the standardized approach. It could reinforce that approach by developing its institutional capabilities through entry-level hiring, which would help it build leaders immersed in “the way we do things around here” right from the start of their careers.

Leadership styles too are a potential constraint on the base case. When the CEO’s job becomes vacant, for example, many companies routinely promote the CFO, and a fair proportion of these executives bring the financial habit of detailed control and checking to the new role. As a result, the management choice of deliberately stepping back from detailed command and control to adopt a more visionary and open approach to leadership is unlikely to succeed. Such a company should stick to its accustomed leadership style.

Command-and-control legacies also come into play for other reasons. One postal operator facing a liberalized market and intense competition initially made its workforce more efficient by using command-and-control techniques focused heavily on financial and operational metrics. An attempt to switch to a visionary style of direction setting in the next phase fell flat because the members of the organization were accustomed to being told what to do. Although an initiative to develop managers who can respond to the visionary style is slowly gaining traction, the company has so far been forced to go on setting its direction from the center and to exert control through financial metrics and motivational incentives.

Strategy too can be a constraining factor. If a company emphasizes M&A, for example, the otherwise desirable option of openness and entrepreneurialism can be problematic simply because entrepreneurial management styles can conflict with centralized value creation.

Furthermore, companies can’t ignore their organizational past. Take one with a rich history of national operating units reflecting different local cultures. When the company decided to merge into a pan-European organization, its future direction was set from the top down, with limited consensus building; detailed individual performance contracts defined accountability, and local leaders were moved to a central hub. The decision to bypass local cultures and to emphasize the performance of individuals rather than teams or units created a major fracture in the new organization. Employees felt unclear about its direction, performance contracts failed to take hold, and both its performance and health suffered.

Most managers are notoriously subjective, prone to manage by anecdote, quick to adopt best practices, and fond of big, visible initiatives. But the evidence from McKinsey's database suggests that a company's performance and underlying health are much more likely to be improved by a combination of complementary practices—especially those that provide for clear accountability, help set goals and priorities, and encourage a high-performing corporate culture. Top managers would be wise to base their actions on this evidence of proven success and not on prevailing wisdom and myths, however seductive.

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