

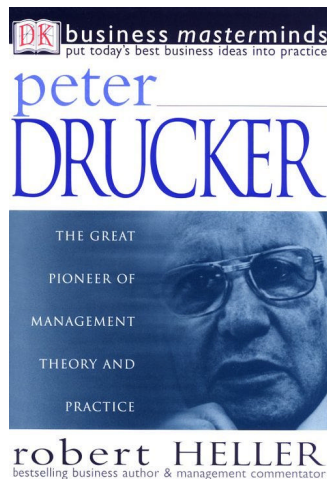
BusinessSummaries

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**INSIDE THE GURU MIND SERIES**

# Peter Drucker

## The Great Pioneer Of Management Theory And Practice



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## Peter Drucker

### The Theory of a Business

Drucker believes that the theory of a business or the assumptions on which a company has been built and is operating on depends on:

- Assumptions about the environment of the organization
- Assumptions about the specific mission of the organization
- Assumptions about the core competencies needed to accomplish the organization's mission

As the organization becomes bureaucratic and sluggish, it becomes extremely difficult to change systems and mindsets when the assumptions are no longer valid. This was the situation that General Motors found itself during the 1980's. In the following pages, Drucker teaches us how to maintain a valid theory of business.

## Organizing for Success in Business

### Decentralized Structure

In 1946, Drucker wrote "Concept of the Corporation," which explores the evolution of the business corporation and its impact on society. The result of 18 months of interviews and observation, the book discusses the beliefs and management style of Alfred P. Sloan, GM's creator.

Drucker noted that GM gave its divisions great independence, which was uncommon by the standards of the day. "In over 20 years of work...Mr. Alfred P. Sloan Jr. has developed the concept of decentralization into a philosophy of industrial management and into a system of local self-government." GM had 50 divisions, and Drucker estimated that all but 5 percent of decisions were within the control of the divisions.

Decisions that did require head office approval had to do with the financial function, pricing, labor costs and capital deployment. Drucker invented the term "profit center" to describe a division, and noted that these groups were held highly accountable for results.

### Corporation as Human Effort

Drucker believes that decentralization is key to the corporation's success. Decentralization creates a pattern of behavior and a basis for the successful solution of majority of problems. Furthermore, it provides an environment for grooming GM executives by placing them in positions where they could take responsibility without endangering the entire company. As they mature and their skills broaden, they are given new positions where they can apply themselves.

Drucker considers the corporation the means by which people could attain their dreams. He considered GM as a representative institution of the “large mass-production plant,” which had become America’s social reality. However, GM was still far from achieving Drucker’s ideal that the corporation should be an engine with which to achieve the greater good. GM’s concept of employment was to churn out the highest volume of cars at the lowest possible cost. The role of the worker was to do as he was told and perform his assigned task on the assembly line with mindless monotony.

### **Self-Governing Plant Community**

Drucker believes in “empowerment” and recommended that GM should create the “self-governing plant community” where members could have a say in workplace decisions and could take pride in their work. He criticized the assembly line on economic and human grounds. He believed the assembly line was inefficient because the line moved only as fast as the slowest worker, no one produced a finished product and the monotony was counter-productive.

While Drucker recognized that the small unit was inefficient and had no place in modern mass production, he also believed that the small unit could best provide the worker economic dignity.

In addition, Drucker believed in giving long-term workers guaranteed annual wages, so that they would be less vulnerable to economic downturns. The workers, in turn, would be properly motivated because they were no longer dispensable to management.

Drucker’s ideas were quite close in nature to those of Walter Reuther, head of the United Auto Workers Union and GM’s adversary, and because of GM’s post-war labor problems, these ideas fell on deaf ears. It was only much later that GM adopted the idea of the guaranteed wage.

### **Corporation as Pillar of Society**

Sloan’s successor, Charlie Wilson, solicited employee opinion in order to improve jobs. His findings revealed that employees wanted “to identify themselves with product and company and to be held responsible for quality and performance.” This desire became the source of post-war management philosophy in Japan. Drucker’s study of GM influenced management practice in companies throughout the world, but his ideas were not welcomed by Sloan.

Despite this, Drucker considered Sloan’s contribution to GM as invaluable and believed that “GM had an even more powerful, and successful, theory of the business than IBM...The company did not have one setback in 70 years – a record unmatched in business history. GM’s theory combined, in one seamless

web, assumptions about markets and customers with assumptions about core competencies and organizational structure.”

### **Theory of the Business**

Drucker defines the theory of a business as a set of “assumptions on which the organization has been built and is being run.” He outlines the conditions needed for the theory to remain valid:

- ❑ The assumptions about the environment, mission, and core competencies must fit reality.
- ❑ The assumptions in all three areas have to fit one another.
- ❑ The theory of the business must be known and understood throughout the organization.
- ❑ The theory of the business has to be tested constantly and altered if necessary.

According to Drucker, GM excelled on the second point. “Its assumptions about the market and about the optimum manufacturing process were a perfect fit. GM decided in the mid-1920’s that it also required new and as-yet-unheard-of core competencies: financial control of the manufacturing process and a theory of capital allocations. As a result, GM invented modern cost-accounting and the first rational capital-allocation process.”

### **Maintaining a Valid Theory**

In order to prevent the collapse of the theory behind a business, there are two preventive measures that organizations can utilize:

- ❑ Challenge the status quo.

“Every three years, an organization should challenge every product, every service, every policy, every distribution channel with the question, ‘If we were not in it already, would we be going into it now?’” This will prompt management to ask the right questions. “Why didn’t this work, even though it looked so promising when we went into it five years ago? Is it because we made a mistake? Is it because we did the wrong things? Or is it because the right things didn’t work?”

- ❑ Study what is going on outside the business.

“The first signs of fundamental change rarely appear within one’s own organization or among one’s own customers.”

Drucker believes that when the organization attains its original objectives, the theory behind it becomes obsolete. Thus, the organization must periodically review its environment, mission and core competencies.

In addition, an organization going through rapid growth is generally in a crisis situation. “Any organization that doubles or triples its size within a fairly short period of time has necessarily outgrown its theory.”

### **Unexpected Success and Failure**

The unexpected success or failure of the company or of its competitors is a sign that the assumptions behind the theory of a business are no longer valid. For example, had GM paid attention to the success of Chrysler’s minivans, it might have realized that the market was changing and that its core competencies had become obsolete. GM could also have seized this opportunity early on by leveraging its expertise in light trucks.

Another unexpected failure was the decline of GM’s market share due to the invasion of Japanese car manufacturers who embraced Drucker’s ideas in “Concept of the Corporation.”

Drucker comments, “My popularity in Japan where I am credited with substantial responsibility for the emergence of the country as a major economic power and for the performance and productivity of its industry, goes back to Concept of the Corporation, which was almost immediately translated into Japanese, eagerly read and applied.”

#### **Ideas into Action**

- Spend all the time you need on making decisions that affect people.
- Make sure that everybody understands what your business is really about.
- Study what is going on outside the business, and among customers and non-customers.
- If the business is growing fast, question your assumptions all over again.
- Look out for and learn from unexpected success – your own and others.
- Do exactly the same with unexpected failure, especially your own.

### **The Art of Management in Practice**

#### **The Scope of Management**

Drucker calls management an art, not a science. He believes that management is a social science that integrates human values and conduct, social order and intellectual inquiry. It makes use of economics, psychology, mathematics, political theory, history and philosophy.

While the curricula at most business schools heavily stress financial analysis and other mathematical disciplines, Drucker insists that this is merely the foundation of managing, not its entirety and that quantification should not be confused with

management. Because of his statistical background, he believes in the importance of financial facts, but considers management “an integrating discipline.”

Drucker maintains that the organizations are more similar than they are different and estimates that 90 percent of management is generic. The principles underlying any organization are the same and the differences arise in application. Drucker also notes that all executives in organizations spend similar amounts of time on people problems and “the people problems are nearly always the same.”

Drucker believes that the main task of management today is leadership and its main goal is improving productivity by utilizing the worker’s strengths and knowledge.

### **Importance of the Customer**

The business should be organized around customer satisfaction, according to Drucker. This theme is consistent in all of his work. “The foundations have to be customer values and customer decisions. It is with those that management policy and management strategy increasingly will have to start.”

### **What Management Does**

#### The 5 Basic Functions of a Manager

1. A manager sets objectives. He decides how to attain these objectives and communicates these objectives to the people who are needed to achieve them.
2. A manager organizes. He identifies the tasks and decisions needed, breaks down activities into manageable jobs, groups the units and jobs into an organization structure and selects people for the jobs.
3. A manager motivates people by making ‘people decisions’ on compensation, promotion and placement. He also fosters team spirit by constant communication with subordinates, colleagues and superiors.
4. A manager measures performance. He establishes yardsticks and ensures that each person is assessed for tasks within his control and that individual objectives are in line with overall company objectives. He ensures that the individual is aware of these metrics and is given the tools to achieve it.
5. A manager develops himself and others.

## Hero Chief Executive

The first four functions require the CEO to play multiple roles: the thought man, action man, people man and front man. Drucker maintains that it is rare to find all four temperaments in one man. “The one-man top management job is a major reason why businesses fail to grow.” Sloan, CEO of General Motors, was an exception. He reduced management to two simple ideas: incentive compensation and “decentralization with coordinated control,” which resulted in breeding motivation among the ranks and creating opportunity for employees.

## Effective Self-Management

Decentralization is dependent on effective self-management, according to Sloan, who advises us to ask ourselves the following questions:

- What am I doing that does not need to be done at all?
- What am I doing that can be done by somebody else?
- What am I doing that only I can do?

Drucker provides a set of questions that can be used to assess individuals and business units. The second step is to measure expectations against actual results in a process called feedback analysis.

### Assess Yourself

- Who am I?
- What are my strengths?
- How do I work?
- Where do I belong?
- What is my contribution?

### Assess Your Unit

- What is its role?
- What are its resources?
- How does it function?
- What is my function within it?
- What are the functions of others?

### Do the Feedback Analysis

1. Whenever you take a key decision or action, write down what you expect to happen.
2. Review results at regular intervals and compare them with expectations.
3. Use this feedback as a guide and goad to reinforce strengths and eliminate weaknesses.

The results will identify what changes are necessary to achieve expectations. In addition, the feedback analysis provides a basis for setting subsequent objectives.

## Measuring Performance

Drucker recommends the use of “business audits” to provide effective business control. Business audits include measuring market standing and the ability to innovate. He states that traditional accounting is unable to give managers the early-warning system they need to make good decisions. In addition, one cannot measure a knowledge company in the same manner as a manufacturing concern. Thus, there is a need to define performance in non-financial terms.

Activity-based costing recognizes the “cost that matters for competitiveness and includes the cost of “not doing” (such as machine downtime). Furthermore, Drucker recommends that managers know the cost of the “entire economic chain,” including the final cost to the customer. He is a strong proponent of “price-led costing” where companies work back from the price the customer is prepared to pay.

## The Diagnostic Toolkit

Four diagnostic tools needed to effectively manage a business:

1. Foundation information – Traditional measures such as cash flow, sales and various ratios are used to detect and treat problems.
2. Productivity information – This includes measuring labor costs, “economic value-added” analysis to show that the business is earning more than its capital costs, and “benchmarking” against competitors.
3. Competence information – Measuring the ability of a company to innovate, or measuring its core competencies. “How many of the truly important innovation opportunities did we miss? Why? Because we did not see them? Or because we saw them but dismissed them?”
4. Resource-allocation information – Measuring return on investment, payback period, discounted present value and asking two key questions:
  - What will happen if the investment fails to produce the promised results? Would it seriously hurt the company?
  - If the investment is successful, especially more so than we expect, what will it commit us to?

“There is no better way to improve an organization’s performance than to measure the results of capital spending against the promises and expectations that led to its authorizations.”



Drucker believes that effective management lies not only in proper resource allocation, but also in the proper placement of people, strategy formulation based on markets, non-customers and customers, and “business intelligence” on actual and potential competitors worldwide.

### **Ideas into Action**

- Make sure you communicate clearly and often with colleagues, superiors and subordinates.
- Do the Feedback Analysis as a matter of course to build on your strengths.
- Gain really effective control by conducting a comprehensive “business audit.”
- Work back to costs from what customers are prepared to pay.
- Look at several measures of capital employment – not just one.
- Have specific expectations for people’s performance and appraise it systematically.
- Develop “business intelligence” about actual and potential competitors worldwide.

## **Managing by Objectives & Self-control**

### **Integrated Management System**

The 6 Stages of Management by Objectives (MBO):

1. Define corporate objectives at board level.
2. Analyze management tasks and devise formal job specifications, which allocate responsibilities and decisions to individual managers.
3. Set performance standards.
4. Agree and set specific objectives.
5. Align individual targets with corporate objectives.
6. Establish a management information system to monitor achievements against objectives.

The MBO technique is a top-to-bottom approach that seeks to control, coordinate and motivate managers, and is hailed as “one of the rational school of management’s most successful products.”

### **Performing in Key Result Areas**

In “The Practice of Management” (1954), Drucker states the 8 key result areas where MBO is applied:

- Marketing
- Innovation
- Human Organization
- Financial Resources

- Physical Resources
- Productivity
- Social Responsibility
- Profit Requirements

Recent opinion has called for more flexibility in determining performance metrics. The focus of discussion these days is how to achieve these objectives. Drucker calls for a balance of empowerment and control. The principle of decentralization espoused by Sloan gives people the freedom to achieve objectives in their own way, but top management hands down the objectives. Drucker states that today's worker is self-managed and has a say in the objectives he is measured against.

### **Managing for Results**

In "The World According to Drucker," Jack Beatty summarizes the 8 perceptions that deliver results in the "outside world," that is, the market and the economy:

- Resources and results exist outside, not inside the business.
- Results come from exploiting opportunities, not solving problems.
- For results, resources must go to opportunities, not to problems.
- "Economic results" do not go to minor players in a given market, but to leaders.
- Leadership, however, is not likely to last.
- What exists is getting old.
- What exists is likely to be misallocated (i.e., the first 10 percent of effort produces 90 percent of the results)
- To achieve economic results, concentrate.

According to Drucker, a sound strategy is one that is customer-focused, entrepreneurial, aimed at market leadership, based on innovation and focused on "decisive opportunities."

### **Intelligent Self-management**

Drucker gives practical advice on how to be an effective self-manager.

- On effective decision-making: Separate the recurring and the unique issues. Recurring issues should be handled by the system, while unique issues should be dealt with independently.
- On improving performance: Determine whether you are more comfortable absorbing information through the written or spoken language. Once you know which is your dominant learning style, you can improve your performance. "...do not try to change yourself – it is unlikely to be successful. But work, and hard, to improve the way you perform. And try not to do work of any kind in a way you do not perform or perform badly."

- On knowing yourself: Join an organization with values that match your own. In addition, ask the post-MBO question “What should I contribute?”
  - Find out what the situation requires
  - Determine how you can make the greatest contribution by matching your strengths, values and way of performing with what needs to be done
  - Determine the results that have to be achieved to make a difference.

### **Ideas into Action**

- Understand that there is no one right way to manage people.
- For best results, give resources to opportunities, not to problems.
- Get to know the organization’s mission and to believe in it.
- Find out what you should do, and how – then go ahead and do it.
- Ask yourself whether you produce results as a decision-maker or an adviser.
- Help yourself and others to learn how to manage yourselves.
- Ask yourself what you should do, rather than simply doing what you are told to do.

## **Harnessing the Power of Innovation**

### **Searching for Changes**

#### Four Sources of Entrepreneurial Opportunities

These are changes that occur within the company or its industry.

- The unexpected – the unexpected success, the unexpected failure, the unexpected outside event  
 Example of unexpected success: The demand for televisions from “poor” Japanese farmers, which Matsushita exploited.  
 Example of unexpected failure: The flop of Edsel, which made Ford realize fundamental shifts in consumer demand.
- The incongruity – between reality as it actually is and the reality as it is assumed to be or as it “ought to be”  
 Example: The rise of the mini-mill at the expense of large integrated steel mills
- Innovation based on process need  
 Example: innovation in eye surgery
- Changes in industry structure or market structure that catch everyone unaware  
 Example: shift in the US from single to group practice

## External Sources of Change

Drucker identifies 3 external sources of change:

- Demographics or population changes
- Changes in perception, mood and meaning
- New knowledge, both scientific and non-scientific

The seven sources of innovative opportunities have overlaps, and innovation stemming from “bright ideas” are more numerous than all the other sources combined. Bright ideas are the “riskiest and least successful,” according to Drucker. They are also vague and unpredictable, but an entrepreneurial economy cannot ignore them because in the end, innovation does not follow rules.

## Principles of Innovation

Drucker believes that “purposeful innovation resulting from analysis, system, and hard work...surely covers at least 90 per cent of all effective innovations.” He cites the five “do’s” of effective innovation:

- Analyze the opportunities.
- Go out and look, to ask, to listen.
- Keep it simple, keep it focused.
- Start small – try to do one specific thing.
- Aim at market leadership.

Drucker recommends that innovations should begin with fewer resources so that the innovator can make corrections based on the initial errors. At the same time, he believes that the ultimate goal should be market dominance.

Drucker also cites the following “don’ts” when working towards innovation:

- Don’t be clever.
- Don’t diversify, don’t splinter, and don’t try to do too many things at once.
- Don’t try to innovate for the future.

“Innovations have to be handled by ordinary human beings [whose] incompetence is...in abundant and never-failing supply. Anything too clever is almost bound to fail.” In other words, if the innovation is too complicated, it will be unappreciated and unsuccessful. The third “don’t” tells us that there must be a current demand for the innovation. Though it takes 10 years to develop a drug, for example, the disease it is meant to cure is prevalent now.

## **Managing Innovation Separately**

Drucker points out that for an entrepreneurial venture to succeed, it should be removed from an existing management system. He believes that the established company will put heavy burdens on the new venture such as a highly structured incentive scheme, return-on-investment targets and unclear accountability for the venture. He sees the difficulty in converting a large corporation, which is organized around rigid lines, into the unstructured mode of the entrepreneur.

## **Forming the Business X-ray**

Aside from independence, Drucker recommends that the someone in top management be assigned “to work on tomorrow as an entrepreneur and innovator.” This manager is also responsible for the “business X-ray”, which furnishes information that will determine the amount of innovation the business requires, its scope and timelines.

Drucker suggests asking 4 questions which are based on the work of Michael J. Kami, a management consultant:

1. How much longer will this product still grow?
2. How much longer will it maintain itself in the marketplace?
3. How soon can it be expected to age and decline – and how fast?
4. When will it become obsolescent?

The answers determine the extent of the gap between what exists and the company’s objectives, and filling this gap is where innovation steps in. Because of the high failure rate and time delays of innovations, Drucker recommends at least three times the innovative effort.

## **Measuring New Ventures**

### **The 4 Requirements for Managing a New Venture**

- Market focus – being flexible enough to spot mistakes, move quickly and turn these mistakes into advantages
- Financial foresight, especially in planning for cash flow and capital needs ahead – Drucker comments that most entrepreneurs tend to be greedy and, therefore, focus on profits. Putting order amidst the chaos in the form of controls, cash flow and capital are what the business needs in the first stages of its life.
- Building a top management team long before the new venture actually needs one and long before it can actually afford one

- A decision by the founding entrepreneur in respect of his or her own role, area of work, and relationships

The difficulty of recruiting a top-calibre management team can be overcome by building the team from within and by dividing roles among the founding group and developing their skills. The difficulty lies in the ability of the founders to evolve with the needs of the venture and their willingness to step down and delegate authority.

### **Entrepreneurial Strategies**

Drucker states that it is much more difficult to develop entrepreneurial strategy than it is to develop inventions and manage. Nevertheless he identifies and describes four types of entrepreneurial strategies:

1. Being the “Fustest with the Mostest” or aiming at market leadership from the beginning
2. “Hitting Them Where They Ain’t” either by imitating and surpassing the original invention or by “entrepreneurial judo” where newcomers take on entrenched companies, a concept highly developed by the Japanese.
3. Finding an “ecological niche” by “obtaining a practical monopoly in a small area.”
4. Changing the economic characteristics of a product, market or industry by
  - a) creating utility – Rowland Hill’s penny post
  - b) pricing – Gillette’s cheap razors and expensive blades
  - c) adaptation to the customer’s social and economic reality – Cyrus McCormick’s leasing of harvesters to farmers
  - d) delivering what the customer perceives as true value – Herman Miller’s move to offer whole office systems instead of individual items

### **Responsible Knowledge Management**

#### **Identifying Future Development**

“For the next twenty or thirty years demographics will dominate the politics of all developed countries. And they will inevitably be politics of great turbulence. No country is prepared for the issues.”

- Management Challenges for the 21<sup>st</sup> Century

Drucker cites the aging of the populations in the West and in Japan as one of the trends that will impact the future. He makes three conclusions from this trend:

- Retirement age will rise. Drucker expects this to be 75 before the year 2010.
- Economic growth can come only from a very sharp and continuing increase in the productivity of knowledge work and knowledge workers.
- There will be no single dominant world economic power. The last conclusion has met debate as the US currently dominates the new technologies and its population is stable in contrast to other developed countries.

### **Extending the Manager's Role**

Drucker believes that management will extend its role to non-profit organizations and social concerns, specifically in education and healthcare, "both of which are today over-administered and undermanaged."

Drucker cites that management's social importance has not managed to catch up with its economic importance, and for management to establish its legitimacy, it must extend its role beyond commercial organizations.

### **Moral Responsibility**

Drucker has stated that he is "appalled and rather scared by the greed to today's executives." He cites as "both obscene and socially destructive" awards of millions of dollars in bonuses "for firing 100,000 workers."

Drucker is unimpressed by the way many businesses are currently managed, and finds the huge wealth awarded to corporate executives unacceptable. While other commentators consider the flow of riches as the beginning of a new growth economy, Drucker sees it as the beginning of the end. Rather, he believes that the growth sector of the 21<sup>st</sup> century will be in the non-profit sector - education, health and religion.