PART 1

TURBULENCE AND PERFORMANCE MANAGEMENT TODAY

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CHAPTER 1

Understanding Turbulence

A time of turbulence is a dangerous time, but the greatest danger is a temptation to deny reality.

—Peter Drucker

Turbulence is growing in today's environment. As this chapter's opening quote ominously warns, the danger posed by turbulence stems not just from turbulence itself but from the temptation of managers to deny it. If the recent economic slowdown and related global financial crisis taught business leaders anything, it is that turbulence is very much here and it is not going away anytime soon. It is a condition that organizations must learn to cope with if they are to survive. This chapter explores the phenomenon of turbulence—difficult-to-predict environmental discontinuities—so as to help leaders gain a better understanding of what turbulence is as well as the debilitating effects it has on organizations today.

The World Is More Turbulent Today

Much information has been circulating today alleging that the business world is more turbulent today than ever before. Is this claim true? We believe it is and in the following sections we discuss findings—from corporate leaders, from the popular business press, and from academic sources—that reinforce this point of view.

c01.indd 3 11/10/11 11:25 AM

Believing Is Seeing

As active researchers and advisors to organizations around the world, we can see that it is becoming a much more volatile place for organizations to operate in. Like most onlookers, we see the political instability in the Middle East reported daily, driven in part by the power of social media as a means of mass communication. We watch changes in capital flows and money as financial centers shift from the United States and Europe to the Far East. We also observe rapid growth and expansion of economies such as China's and India's. And we are not the only ones who view the world as becoming more turbulent.

When we talk to managers in the organizations we advise and in our executive education sessions, most feel that the world is getting increasingly unpredictable compared to just a few short years ago. Indeed, very few see it as less so. Capital markets contracted overnight as a result of the credit crisis, which made lending not just difficult, but impossible for some organizations. Demand for products and services, from automobiles to air travel, fell off precipitously. Companies were forced to scale back investments and quickly moved to trim workforces to face the new realities in front of them. Entire industries, such as publishing and film processing, are evaporating while new ones such as online retailing and digital audio grow explosively. Areas of business that were once stable or at least moderately reliable are now experiencing significant destabilization if not wholesale decline. Consider the following examples:

- A technology-based organization with a hundred-year history of successful process and product development in its core business finds its primary market reduced by over 50 percent in the span of five years due to the introduction of a competing technology.
- A company with a successful track record of offshore product manufacturing sees in the span of 18 months both a massive reduction and subsequent spike in demand it must contend with using a Far East–based source of supply that has a three- to four-month product shipment time.
- A regional construction firm, heavily reliant on government infrastructure projects, experiences a significant slowdown in

demand due to a reduction in spending that persists for four to five years, which forces it to shift into markets where it has never competed before.
- An international law enforcement organization undergoes a catastrophic external shock followed by a public mandate that requires altering its scope, shifting it from an entity focused largely on domestic crime fighting to one focused on both crime fighting *and* global intelligence dissemination.
- A branch of the military known for its rapid and ready ability to deploy has to reorient itself to engage in a decade of sustained ground combat in two theaters of conflict while still maintaining its rapid strike capabilities.

At first glance, these anecdotes may seem unrealistic or, at least, highly improbable given the magnitude of the challenge confronted by each organization. They may even seem fictitious, made up only to illustrate points in this book. Rest assured these are actual organizations and the challenges they face are very real examples taken from our own research and consulting. The plain fact is that organizations of all sizes, and at all levels, are being forced to change on an unprecedented scale due to turbulence. Organizations and their leaders have little choice but to respond or suffer the consequences associated with missed opportunities and challenges in performance.

Observations from Business Leaders

These are not only our observations. Senior managers from all types of organizations share these views. Business leaders are keenly aware of the pressures that confront them daily, and they, too, acknowledge that times have changed—perhaps permanently. Consider these observations from some leading executives:

> The question is: given the megatrends in the world and given the new economy, what changes do we have to make to continue to be successful? There is no playbook for what we are experiencing today.
>
> *—Ellen Kullman, CEO, DuPont, to attendees at a Wharton Leadership Conference*

> On the business front, we face a growing global marketplace and far-flung organizations that span time zones and country borders. Information overload and the sheer pace of change have reached new heights.
>
> *—Ingar Skaug, Chairman of the Center for Creative Leadership, in a newsletter to members*

> These are challenging markets, and the turbulence we've seen in recent months isn't likely to subside anytime soon.
>
> *—John Mack, CEO, Morgan Stanley, in a memo to employees*

> The world your managers are dealing with is just more volatile than it used to be. You've got to find a way to buffer your investors and your employees from these wild swings.
>
> *—Jeff Immelt, CEO, General Electric, to MBA students at Stanford University's Graduate School of Business*

> When you think about turbulent times, frankly, business is always in turbulent times—there are just degrees of turbulence.
>
> *—Hugh Grant, Chairman and CEO, Monsanto, at Towers Perrin HR Roundtable*

Hugh Grant (listed tenth among 2010's top CEOs by *Harvard Business Review*) is one leader who has been vocal on the topic. In a 2008 speech, he discussed the challenge of leading during turbulent times. When he was originally asked to discuss this topic, he planned a presentation geared to focus on explosive growth in the expanding agriculture markets in which his company participates, but between his acceptance of the invitation and the delivery of his speech came the 2008 financial meltdown. "In the last few weeks," he opined to his audience, "I think turbulence has taken on a whole different meaning. Now the challenge is, how do you lead when the economic and the financial environment that we live in is crumbling?"

This is the nature of turbulence—rapid and oftentimes unforeseen changes in environments that can dramatically alter the path and performance of organizations.

Thoughts from the Popular Press

The popular business press is quick to pick up on tastes and trends. In the main, they have spotted the underlying belief in increased

c01.indd 6 11/10/11 11:25 AM

levels of turbulence. The sense is that predictability has given way to the unpredictable in the business community now that the Information Age has swept across the organizational landscape.

The standard bearer for the new era of irrationality may be Alan Greenspan, former Chairman of the Federal Reserve, the central bank of the United States. Noted for coining the phrase, "irrational exuberance," a description of the stock market's stratospheric growth during the later stages of his tenure, Greenspan published the acclaimed book *The Age of Turbulence*: *Adventures in a New World,* in which he chronicles the massive transformation that took place during his time in office from 1987 to 2006.[1] The economy effectively globalized and became significantly more free flowing, self-governing, and rapidly changing. He sees a world of possibilities, but one full of challenges as well, by-products of turbulence associated with changing capital markets.

In 2008, acclaimed marketing professor Philip Kotler and his colleague John Caslione published *Chaotics: The Business of Managing and Marketing in the Age of Turbulence.*[2] This concise and well-reviewed text posits a variety of causes of turbulence. These authors, too, identified increasing globalization in the economy and the interlocked proliferation of technology. Turbulence, even chaos, is now the new normality. Organizations need to equip themselves and prepare for management in this new world. Kotler and Caslione provide a system they call the Chaotics Management System, intended to help organizations sense changes in the marketplace, develop scenarios from those signals, and then respond via one of their predetermined responses. They continue by explaining how to align business activities and functions with the Chaotics Management System and conclude by demonstrating how common responses to turbulence no longer work in the new globalized economy.

In 2009, London Business School professor and former McKinsey consultant Don Sull wrote a compelling book that explained and described how organizations can capitalize on volatility, *The Upside of Turbulence: Seizing Opportunity in an Uncertain World.*[3] The book is based upon his research of companies operating in turbulent industries, such as steel and technology, along with his personal observations. Interviewed by the *McKinsey Report,* Sull sees the current economic crisis "as just the latest symptom of underlying turbulence that's been on the rise for at least 20 or 30 years."[4] What is new is

the severity and persistence, a fact that business leaders must learn to cope with.

The Economist Intelligence Unit published a research report in 2009 entitled "Organisational Agility: How Businesses Can Survive and Thrive in Turbulent Times."[5] The report, sponsored by EMC Corporation, is based on interviews of just under 350 executives from around the world and makes four key findings. The first, and perhaps most important, is that 90 percent of executives believe that organizational agility is critical to success in the today's business environment. *Agility*, according to business leaders, comprises rapid decision making and execution. The second finding, related to the first, is that leaders believe that their organizations are not flexible enough to respond to today's changes. Over one-quarter of the respondents felt their organizations were at a competitive disadvantage due to poor agility. The third finding reveals that more than 80 percent of the leaders polled claim their organizations have initiatives designed to improve agility, but one in three found these initiatives had failed to deliver results. Finally, technology was deemed to play a critical role in enabling organizational agility. Traits respondents identified as those of an agile organization are listed in Figure 1.1.

We could continue, but it is safe to note that among popular—and credible—publications, there is a sense that the world is moving faster and organizations need to develop systems and structures to keep pace. But popular business thinking alone is insufficient to build the case; we also need to explore the available research evidence.

Figure 1.1 Traits of Agile Businesses

Source: Adapted from Economist Intelligence Survey 2009.

Evidence from Researchers

In 2006, two economics researchers, Diego Comin of Harvard Business School and Sunil Mulani, a senior analyst at Commonfund Capital, examined volatility at the individual company level using a sample of U.S. domestic firms. The sample, drawn from the COMPUSTAT database, examined publicly traded companies' net sales over rolling 10-year periods from 1950 until 2002. They ran several tests and found that the growth rates of sales at the firm level were becoming more volatile over time, effectively doubling over the time period examined. The same was true for profitability and employment. The trend of revenue is shown in Figure 1.2.

Two other Harvard Business School researchers, George Baker and Robert Kennedy, examined over 7,000 firms trading on the New York and American Stock Exchanges from 1963 to 1995.[6] They found the annual churn rate was high and there was a significant ongoing change in the market population. Only 6 out of 10 firms survive on average and the odds that a firm would disappear doubled from the start of the period to the end.

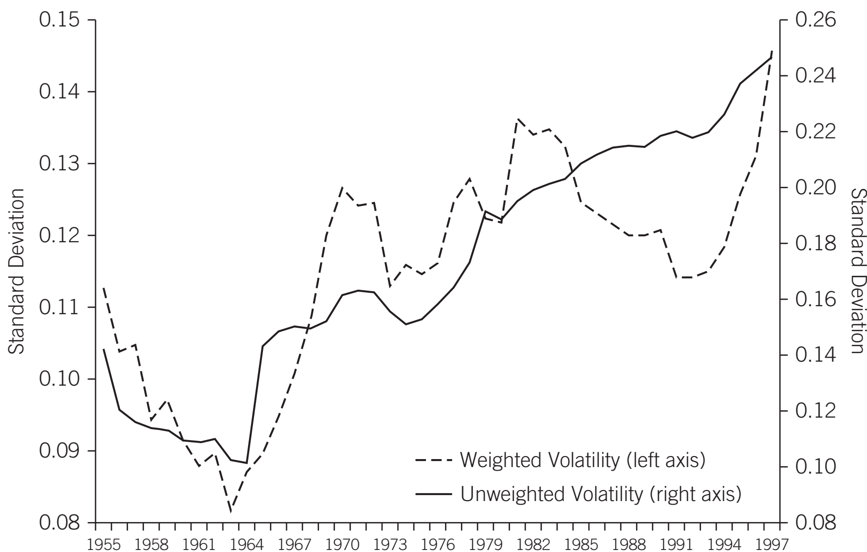

Figure 1.2 Volatility of the Growth Rate of Real Firm-Level Sales

Source: Reprinted from *Review of Economics and Statistics* 88, no. 2, Diego Comin and Sunil Mulani, "Diverging Trends in Aggregate and Firm Volatility," pp. 374–383. Copyright © 2006 by the President and Fellows of Harvard College and the Massachusetts Institute of Technology

Three researchers at Corporate Executive Board examined what they called company "stall points," where company growth falters and then falls off significantly. They looked at nearly 500 publicly traded firms from 1955 to 2000, examining 25,000 years of data.[7] They found that 87 percent of firms—almost 9 out of 10—stalled at least once during the period and those firms lost 74 percent of their market capitalization in the 10 years following the stall.

From our research, we found statistics that suggest increased rates of turbulence at the company-specific level. Of the 20 largest bankruptcies that occurred during the past 30 years in the United States, almost half occurred within the past three years, and four of those were among the largest of all time—Lehman Brothers, Washington Mutual, General Motors, and CIT Group.[8] Applications for patents in the United States grew 67 percent from 1999 to 2009 and the foreign share of U.S. patents grew from 45 percent to 51 percent during the same period, signaling that competition is intensifying not only from within the United States but from beyond as well.

The final, and most eye-opening, research came from well-known strategy researchers Andrew Henderson, Danny Miller, and Don Hambrick, who studied the speed at which CEOs become obsolete. Previous studies found that as new CEOs learned their job and applied their skills, they were effective when change in their industries took place over a longer period, before their knowledge and skill sets became stale. In their analysis of 288 high-technology CEOs, however, Henderson et al. found that CEOs could not adapt their mental models and paradigms of effectiveness to their new firms at a speed that kept up with a changing environment.[9] Their approaches and mind-sets tended to become obsolete very quickly in a highly dynamic and turbulent business landscape.

Based on our observations and various types of evidence from multiple sources, it is clear that turbulence levels are growing and the effect on organizations is significant, unavoidable, and must, in some way, be dealt with. But before we address how to cope with turbulence we need to first understand what it is.

Understanding Turbulence

Most people first encounter the word "turbulence" in relation to flying. Typically, aircraft fly free of turbulence. The air is void of any significant movement and the pilot guides the plane without

much effort. Passengers enjoy a safe, comfortable takeoff, journey, and landing. Sooner or later, however, an aircraft flies into an area of turbulence, which the Federal Aviation Association (FAA) defines as "[a]ir movement that normally cannot be seen and often occurs unexpectedly. It can be created by many different conditions, including atmospheric pressure, jet streams, air around mountains, cold or warm weather fronts or thunderstorms."

Noteworthy is the fact that turbulence cannot be seen and occurs without warning. Yet the feeling of passing through turbulence—especially high levels of turbulence—is unmistakable. Much of the modern equipment used in aviation, such as conventional radar, is unable to detect turbulence, which is why it is so dangerous to passengers. Oftentimes turbulence occurs above 30,000 feet, about where the pilot turns off the fasten-seatbelt lights. According to other data from the FAA, in-flight turbulence is the leading cause of airline injuries to passengers and flight attendants.

Turbulence has other sources as well, including changes in weather, air temperature, and pressure, and sudden movements caused by changes in the jet stream. These characteristics of air turbulence have much in common with the turbulence that organizations experience and must navigate in their own environments.

Turbulence in Organizational Environments

Turbulence for organizations does sound like flying through the air. Management researchers refer to "high-velocity environments," "fast-moving industries," and "hypercompetitive settings." To be sure, each of these terms is related to our core concept of turbulence. When change is occurring quickly and from a number of different sources within an environment—from competitors and technology, for example—the resulting effect is an increased level of instability, or, in other words, *turbulence.* The following is the definition we will use throughout the book:

> *Turbulence* refers to volatility or difficult-to-predict discontinuities in an environment.

The level of turbulence in an environment is the result of three different underlying dimensions: dynamism, complexity, and

munificence. *Dynamism* refers to the rate of change or the degree of change that is occurring in key elements of an underlying environment. *Complexity* refers to the number, the configuration, and interrelationship of environmental variables that the organization encounters in its operations. *Munificence* is the degree to which the environment can accommodate sustained growth.[10,11] The dimensions do not themselves cause turbulence; they are simply the lens through which turbulence can be seen. The actual factors that contribute to turbulence, while potentially many, can be reduced to five categories: technology, product, demand, regulatory, and competitive.

Technology Factors Technology change refers to change in the rate and direction of production or process within an industry. For example, the advent of digital media represented a major technology shift for traditional media industry participants such as recorded music and motion picture production companies. The ability to create, modify, store, and transfer media digitally has affected the media business from the production of media all the way through the distribution and, ultimately, the consumption—which has its own technology advances that enable easy entertainment media storage, sharing, and management.

Product Factors Changes in the rate and direction of new product introductions can be grouped under product factors. As mentioned earlier, the number of new patents introduced has grown steadily over the past 10 years. New products can cause significant turbulence, depending upon their success rates. While some represent modest advances, other patented products will ultimately revolutionize their industries. Take, for instance, this excerpt from the abstract of a new product patent issued in February 2011:

> U.S. Patent 7,889,497
>
> Description: Highly portable media device
>
> Abstract: An improved portable media device and methods for operating a media device are disclosed. According to one aspect, the portable media device can also function as a solid-state drive for data storage. The form factor of the portable media device can be hand-held or smaller, such that it is highly portable. The portable media device has the capability to store

> media device status information in persistent memory before powering down. Thereafter, when the portable media device is again powered up, the stored media player status information can be retrieved and utilized. According to still another aspect, the portable media device can form and/or traverse a media asset playlist in an efficient manner.
>
> Inventors: Jobs, Steve (Palo Alto, CA); Fadell, Anthony M. (Portola Valley, CA); Ive, Jonathan P. (San Francisco, CA)
>
> Assignee: Apple, Inc. (Cupertino, CA)

Demand Factors Many corporate leaders are painfully aware of changes in demand that have impacted their organizations over the past few years. Demand changes—both up and down—reflect the willingness or ability of market participants to pay for products or services. In the residential lighting market, demand for household fixtures sold through major retailers such as Home Depot and Lowe's was reduced by over half in the span of 24 months. In the auto industry, especially in the heavy equipment sector, data suggests that demand for new product fell by up to 80 percent at the peak of the recent economic downturn.

Regulatory Factors The introduction of laws and regulations governing the actions of organizations in a particular industry can cause significant volatility and dramatic change in the way they operate. As the financial crisis was unfolding in 2008, Secretary of the Treasury Henry Paulson obligated the largest banks in the United States to accept what became known as *bailout money*. The purpose was to shore up bank balance sheets and boost investor confidence after the collapse of some of the biggest financial institutions in the United States. These government loans created a substantial burden for banks as well as their investors and the consumers of bank services.

Competitive Factors Competitive factors represent change in the rate and composition of competition within an industry. The number of competitors, the intensity of their competition, and the activity level among them (mergers, alliances, and the like) contribute significantly to the level of dynamism with an industry. In the global brewing industry, for example, two recent mergers created global giants SABMiller and Anheuser-Busch/In-Bev, which produce 500 types of

beer worldwide. This type of activity creates significant turbulence for firms—it forces them into potentially cost-disadvantaged positions within their industries.

Effects of Turbulence on Organizations

Like the turbulence that disrupts normal cabin activities for both the flight crew and passengers of an airliner in flight, turbulence in organizations has unfavorable effects on management teams when not recognized or managed properly. Many leadership teams will (in keeping with the airplane metaphor) simply take their seats, fasten their seatbelts, and hope the turbulence passes quickly. As we have pointed out, however, the likelihood that volatility in markets and organizations will somehow abate quickly is remote. Doing little more than hunkering down isn't a sensible response for leaders operating in organizations that need to be fast-moving today—especially those that have the willingness to capitalize on the *opportunity side* of turbulence. Those that remain in a defensive posture will feel harmful effects in both the short and long term on their organizations. The following unfavorable results are associated with the inability to manage turbulence.

Loss of Ability to Detect Market Changes

Much of today's increase in turbulence can be attributed to factors that are external to organizations. Increases in regulation, changes in capital availability, and changes in lifestyles or consumer attitudes have all occurred in the external operating environment. Thus, changes in market speed and composition are common features of heightened turbulence.

Unfortunately, heightened turbulence causes many management teams to focus inward—responding with well-worn tactics such as cutting costs and reorganizing in response to uncertain conditions. While improving operating efficiencies and enhancing internal alignment of an organization are important in any environment, during turbulence these changes tend to reinforce the belief that the best responses to turbulent times are internal ones. In reality, the best responses to turbulence are externally focused. Management teams need to reorient their attention—one of their scarcest resources—to the outside world, scanning the horizon for the sources of turbulence. Once identified, these sources can be

understood, analyzed, and discussed among the executives with the express purpose of determining responses that make the best sense. As leaders consciously maintain their focus on the external environment, not only will they develop the ability to detect pending changes earlier, they can formulate proactive responses that capitalize on turbulence rather than simply enduring it.

Slower Decision Making

Rapidly changing conditions outside an organization and across multiple variables require management teams to interpret those changes more quickly and accurately and respond more decisively than in stable conditions. In turbulent environments, time is at a premium and those organizations that survive and thrive are the ones that have mastered the ability to make rapid, effective decisions in the absence of complete information and without the luxury of excess time.

Yet many management teams struggle to make effective decisions in this situation. They feel the increased pressure and anxiety associated with the uncertainty underlying changing conditions. They also realize that critical information is not available when needed and will likely not be available in time to facilitate a thoughtful decision. Consequently, managers will delay major decisions, such as resource reallocation, a major new product launch, or a technology upgrade, at a time when they should probably be accelerating their execution. Slower decision making leads to lost opportunity and increases the likelihood the organization will fall out of step with competitors—at best temporarily, and in the worst cases, permanently.

Reinforcement of Inertia

Inertia is defined as "the indisposition to motion, exertion, or change." In rapidly changing situations, where managers are unable to detect changes that are occurring in their environments—and unable to rapidly respond with plausible course corrections—they will by choice or by default maintain a steady course when their best course of action may be a change in direction.

Most people resist change. It stands to reason, then, that groups of people—such as management teams—comprised of individuals who themselves are change resistant will collectively be change resistant. Case research has shown this to be true. Throughout the

twentieth century, renowned firms such as U.S. Steel and IBM rose to industrial prominence and near total domination in their markets. Yet they failed to see—or at least acknowledge—major changes occurring in their business. U.S. Steel was unable to accurately assess the impact of both foreign competition and new mini-mill technology on their business. IBM fell prey to the shift from mainframe computing to personal computing. Both firms struggled for almost two decades to return to more competitive positions. IBM has returned to prominence by focusing on services and evolving the mainframe business. U.S. Steel continues to generate losses and today is not considered among the world's top 10 steel manufacturers.

Confusion Regarding Sources of Performance Issues

As turbulence impacts the performance of an organization, the cause or source is often unclear to managers. Despite years of research and implementation of balanced performance measurement systems, traditional financial performance measures still dominate the landscape. Furthermore, managers feel that they lack the information needed to capture bona fide performance insights for their performance measurement systems.

Recently, Cranfield School of Management conducted a study with Oracle Corporation to ascertain the global performance measurement practices of various organizations. The study found, among other things, that in over half of all organizations, financial performance measures still dominate performance evaluation. Also, the data revealed a significant "insight gap"—that is, a failure to understand what leads to performance in an organization. According to the report, today's performance measurement systems "do not accurately assess the effect management's choices have on operations until well after the actions are completed." In a fast-moving environment, a clear understanding of performance issues is critical to the successful navigation of a changing environment.

What We're Seeing in Practice Today

Every day, in the course of our research, teaching, and consulting, we encounter organizations struggling to meet their performance goals in today's operating environment. As an example, one of us recently asked a group of CEOs if they thought the pace of today's business environment was increasing. The answer was a resounding "yes." Indeed, the effects of turbulence that we present are

converging to make performance management within organizations more challenging than ever before. What we are seeing from practice has us both concerned and eager to help.

Organizations Are Struggling in Today's Environment

Information now flows faster than it ever has before, thanks to the Internet and other technological advancements, the latest of which—social media—is revolutionizing the way consumers communicate. Managers are continuously connected to their work through e-mail, instant messaging, texting, as well as the traditional channels of personal phone calls, face-to-face meetings, and the like. The workday is now continuous as leaders work nonstop, given that technology has blurred the lines between office and home. Moreover, as the pace of technology introduction quickens, new technologies develop, new companies emerge, and long-standing technologies and business practices become swept up into a pounding sea of competition where traditionally dominant firms no longer have the advantage. Companies such as Google, Facebook, and Amazon, which were not even participants in the business landscape just a few short years ago, are now global giants that have dramatically impacted the way we search for information, share it, and even read it.

The instruments we use to track firm progress just can't keep up with these developments. In the 1980s people predicted a measurement revolution, in which nonfinancial measures would supplement financial measures. We now predict a management revolution where turbulence will drive the need for radically new ways of monitoring and managing organizational performance.

Existing Performance Measurement Approaches Do Not Work in Turbulent Environments

We know from existing literature, as well as our own research, that many traditional performance management practices do not work well in turbulent environments. In turbulent environments the need for timely information grows significantly. Managers must detect and interpret information much more rapidly. They have to make faster decisions. They have to execute more quickly with a narrower margin for error. And they must embrace new ways of operating versus exclusively focusing on exploiting core businesses. Management teams must work together more effectively, sharing information broadly and making sense of their environments while accepting

challenges and executing with focus and speed. What enables these critical activities is a performance management system designed for effective functioning in highly turbulent settings.

Doing More of the Same No Longer Works

CEOs are having a difficult time adapting their thinking and actions to the turbulent times in which we all now live. What we see many doing is focusing on things that we know are not working—exclusive emphasis on financial management, continuous reorganization, reexamination of internal organization, and reduction in the most potent investments available to the organization. Leaders cannot expect to navigate themselves and their organizations out of turbulence by doing more of those things that got them there in the first place. A new approach to organizational performance management is needed, one that has the flexibility and adaptability to deliver best in class results.

Summary

Sufficient evidence exists to conclude the business world is more turbulent and volatile today than ever before. In some settings, the regulatory environment has changed dramatically. In others, product demand has declined precipitously, new technology is sweeping entire industries away, and competition is as intense as ever before. All of this is happening in an incredibly short period of time. Like an aircraft buffeted about by air turbulence, many public and private organizations are now being tossed around by unanticipated forces at work in their environments. The effects can be significant and painful, and can persist for long periods of time. Tried-and-true performance management approaches and management responses now have limited efficacy. New tools and techniques are needed to help managers not only endure, but thrive in this setting. We introduce these in our next chapter.

Case Study: The Decline of the Handleman Company

The Handleman Company is a startling example of how turbulence can impact an organization and further, it illustrates each of the four effects described earlier.

Founded in 1934, Handleman grew to a $1.3-billion-plus category manager and distributor of compact discs, music DVDs, and

video games by 2006. With operations throughout the United States, the United Kingdom, and Canada, the company serviced notable clients, such as Wal-Mart and Kmart, providing in-store merchandising and promotions to maximize the value of purchases made from within the music category.

But the emerging digital music technology, which started in the late 1990s, and with it the ability of computer users to share files over the Internet, began undoing Handleman's business within a very short time. In 2006, the company's best year from a revenue standpoint, there was virtually no mention of digital audio in the company filings. In the annual 10K report, in which the company highlighted specific risks to its operations, there is one reference to music piracy, the only indication that Handleman was aware of the impending change. In fact, just as the world was about to dramatically change, the company made the following statement regarding their key elements of success in the future:

> COMPETITION
>
> Although Handleman Company cannot make any assurances, it believes that the distribution of home entertainment products will remain highly competitive and that customer service, sales to consumers and continual progress in operational efficiencies are the keys to growth and profitability in this competitive environment.

But within two years, the company had begun to feel the dramatic effects of the digital music revolution, with sales falling to under $500 million from the high of $1.3 billion in 2006. The following is an excerpt from their 2008 Form 10K filing, where the company acknowledges the significance of the change:

> RECENT DEVELOPMENTS
>
> In recent years, music industry sales have declined at double-digit rates as the industry was impacted by digital distribution, downloading and piracy. In addition, the Company's gross margins were compressed because lower-margin promotional products became a greater proportion of annual sales. This level of continued erosion of CD music sales is expected to continue into the foreseeable future. In response to this dramatic decline, the Company implemented significant cost reduction plans to reduce

> expenses and streamline operations. These plans included workforce reductions; the consolidation of the operations of two U.S. automated distribution facilities into one facility; the reduction of benefits programs and realignment of medical plans; initiatives to reduce customer product returns; and various other cost cutting initiatives. However, the reduction in music sales volume and the loss of gross margin outpaced the Company's ability to reduce overhead costs; as a result, the Company experienced steep operating losses in the past two fiscal years.

Clear from the excerpt is the fact that managers—even when faced with what obviously is a tectonic shift in their industry—continued to respond with traditional tactics intended to preserve their core business franchise. Unable to navigate the changes within the industry, the company subsequently filed for bankruptcy and was dissolved on May 5, 2009.

Notes

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