HARVARD BUSINESS REVIEW

CLASSICS

THE THEORY OF THE BUSINESS

Peter F. Drucker

Not in a very long time—not, perhaps, since the late 1940s or early 1950s—have there been as many new major management techniques as there are today: downsizing, outsourcing, total quality management, economic value analysis, benchmarking, reengineering. Each is a powerful tool. But, with the exceptions of outsourcing and reengineering, these tools are designed primarily to do differently what is already being done. They are "how to do" tools.

Yet "what to do" is increasingly becoming the central challenge facing managements, especially those of big companies that have enjoyed long-term success. The story is a familiar one: a company that was a superstar only yesterday finds itself stagnating and frustrated, in trouble and, often, in a seemingly unmanageable crisis. This phenomenon is by no means confined to the United States. It has become common in Japan and Germany, the Netherlands and France, Italy and Sweden. And it occurs just as often outside business—in labor unions, government agencies, hospitals, museums, and churches. In fact, it seems even less tractable in those areas.

The root cause of nearly every one of these crises is not that things are being done poorly. It is not even that the wrong things are being done. Indeed, in most cases, the *right* things are being done—but fruitlessly. What accounts for this apparent paradox? The assumptions on which the organization has been built and is being run no longer fit reality. These are the assumptions that shape any organization's behavior, dictate its decisions about what to do and what not to do, and define what the organization considers meaningful results. These assumptions are about markets. They are about identifying customers and competitors, their values and behavior. They are about technology and its dynamics, about a company's strengths and weaknesses. These assumptions are about what a company gets paid for. They are what I call a company's *theory of the business*.

Every organization, whether a business or not, has a theory of the business. Indeed, a valid theory that is clear, consistent, and focused is extraordinarily powerful. In 1809, for instance, German statesman and scholar Wilhelm von Humboldt founded the University of Berlin on a radically new theory of the university. And for more than 100 years, until the rise of Hitler, his theory defined the German university, especially in scholarship and scientific research. In 1870, Georg Siemens, the architect and first CEO of Deutsche Bank, the first universal bank, had an equally clear theory of the business: to use entrepreneurial finance to unify a still rural and splintered Germany through industrial development. Within 20 years of its founding, Deutsche Bank had become Europe's premier financial institution, which it has remained to this day in spite of two world wars, inflation, and Hitler. And, in the 1870s, Mitsubishi was founded on a clear and completely new theory of the business, which within 10 years made it the leader in an emerging Japan and within another 20 years made it one of the first truly multinational businesses.

Similarly, the theory of the business explains both the success of companies like General Motors and IBM, which have dominated the U.S. economy for the latter half of the twentieth century, and the challenges they have faced. In fact, what underlies the current malaise of so many large and successful organizations worldwide is that their theory of the business no longer works.

Whenever a big organization gets into trouble–and especially if it has been successful for many years–people blame sluggishness, complacency, arrogance, mammoth bureaucracies. A plausible explanation? Yes. But rarely the relevant or correct one. Consider the two most visible and widely reviled "arrogant bureaucracies" among large U.S. companies that have recently been in trouble.

Since the earliest days of the computer, it had been an article of faith at IBM that the computer would go the way of electricity. The future, IBM knew, and could prove with scientific rigor, lay with the central station, the ever-more-powerful mainframe into which a huge number of users could plug. Everything—economics, the logic of information, technology—led to that conclusion. But then, suddenly, when it seemed as if such a central-station, main frame-based information system was actually coming into existence, two young men came up with the first personal computer. Every computer maker knew that the PC was absurd. It did not have the memory, the database, the speed, or the computing ability necessary to succeed. Indeed, every computer maker knew that the PC had to fail—the conclusion reached by Xerox only a few years earlier, when its research team had actually built the first PC. But when that misbegotten monstrosity—first the Apple, then the Macintosh—came on the market, people not only loved it, they bought it.

Every big, successful company throughout history, when confronted with such a surprise, has refused to accept it. "It's a stupid fad and will be gone in three years," said the CEO of Zeiss upon seeing the new Kodak Brownie in 1888, when the German company was as dominant in the world photographic market as IBM would be in the computer market a century later. Most mainframe makers responded in the same way. The list was long: Control Data, Univac, Burroughs, and NCR in the United States; Siemens, Nixdorf, Machines Bull, and ICL in Europe; Hitachi and Fujitsu in Japan. IBM, the overlord of mainframes with as much in sales as all the other computer makers put together and with record profits, could have reacted in the same way. In fact, it *should* have. Instead, IBM immediately accepted the PC as the new reality. Almost overnight, it brushed aside all its proven and time-tested policies, rules, and regulations and set up not one but two competing teams to design an even simpler PC. A couple of years later, IBM had become the world's largest PC manufacturer and the industry standard setter.

There is absolutely no precedent for this achievement in all of business history; it hardly argues bureaucracy, sluggishness, or arrogance. Yet despite unprecedented flexibility, agility, and humility, IBM was floundering a few years later in both the mainframe and the PC business. It was suddenly unable to move, to take decisive action, to change.

The case of GM is equally perplexing. In the early 1980s—the very years in which GM's main business, passenger automobiles, seemed almost paralyzed—the company acquired two large businesses: Hughes Electronics and Ross Perot's Electronic Data Systems. Analysts generally considered both companies to be mature and chided GM for grossly overpaying for them. Yet, within a few short years, GM had more than tripled the revenues and profits of the allegedly mature EDS. And ten years later, in 1994, EDS had a market value six times the amount that GM had paid for it and ten times its original revenues and profits.

Similarly, GM bought Hughes Electronics —a huge but profitless company involved exclusively in defense—just before the defense industry collapsed. Under GM management, Hughes has actually increased its defense profits and has become the only big defense contractor to move successfully into large-scale nondefense work. Remarkably, the same bean counters who had been so ineffectual in the automobile business—30-year GM veterans who had never worked for any other company or, for that matter, outside of finance and accounting departments—were the ones who achieved those startling results. And in the two acquisitions, they simply applied policies, practices, and procedures that had already been used by GM.

This story is a familiar one at GM. Since the company's founding in a flurry of acquisitions 80 years ago, one of its core competencies has been to "overpay" for well-performing but mature businesses—as it did for Buick, AC Spark Plug, and Fisher Body in those early years—and then turn them into world-class champions. Very few companies have been able to match GM's performance in making successful acquisitions, and GM surely did not accomplish those feats by being bureaucratic, sluggish, or arrogant. Yet what worked so beautifully in those businesses that GM knew nothing about failed miserably in GM itself.

What can explain the fact that at both IBM and GM the policies, practices, and behaviors that worked for decades—and in the case of GM are still working well when applied to something new and different—no longer work for the organization in which and for which they were developed? The realities that each organization actually faces have changed quite dramatically from those that each still assumes it lives with. Put another way, reality has changed, but the theory of the business has not changed with it.