“A tremendous source of analysis, best practices and actionable insights that will enable any successful enterprise to continue to innovate in today’s fast-changing environment.”

- Brad Smith, President & CEO of Intuit
Google has a stratospheric market capitalization, but the company that organizes the world’s information could easily have been tens of billions of dollars richer. In October, 2004, Evan Williams, who had joined the company when it acquired his startup Blogger, left after a year of chafing under corporate bureaucracy. Blogger product manager Biz Stone departed 11 months later. The pair went on to found Twitter. The new venture went public in November, 2013, and was worth $30 billion by December.

Losing Williams and Stone was an expensive mistake, but Google didn’t learn the lesson. Ben Silbermann joined the company in 2006 after a stint as an IT consultant. He spent nearly two years working on display advertising products but felt out of place as a non-engineer in an engineering-centric corporate culture. He resigned and co-founded Pinterest, the online pin board service that was valued at $3.8 billion as of November 2013.

Google still didn’t get the message, and Kevin Systrom left the company in 2009 after two years of feeling stifled by organizational politics. Not long afterward, he co-founded Instagram, which he sold to Facebook for $1 billion in April, 2012.

Williams, Silbermann, and Systrom — not to mention founders of Asana, Cloudera, Foursquare, Ooyala, and dozens of
other young companies — quit because they were unable to exercise their entrepreneurial talents within a large enterprise. That’s right: Google, the iconic Silicon Valley success story that regularly shows up on lists of the world’s most innovative companies, left at least $40 billion on the table because it failed to retain its most entrepreneurial employees.

That’s bad news for a paragon of innovation. But it’s good news for large, established companies that have tried and failed to foster innovation within their own walls. It means that even the most innovative operations are passing up billion-dollar ideas that an enterprise could pick up and run with. It also means that, among the thousands of workers laboring away in diverse corporate business units and far-flung offices, there are likely to be scores who have ideas that could create tremendous value. Even the stodgiest companies don’t need to repeat Google’s costly mistakes. Enterprises seeking to build new high-growth businesses can unlock and retain latent entrepreneurial talent. They can create an organization that innovates successfully, predictably, and repeatably — not by chance, but because it’s built for the job.

Enterprises in Peril

The need for enterprises to innovate has never been more acute. Established brands are on the ropes. American Airlines was valued at just $5.5 billion at the time it merged with US Airways in 2012. Kodak, a name synonymous with photography for over a century, retreated into bankruptcy in 2012, with its arch competitor Olympus close behind. Suzuki’s automotive division fled the US the same year, and Volvo appears to be approaching the off ramp. Two cornerstones of the PC industry, HP and Dell (which sold itself for $24 billion in early 2013), are crumbling while desperately trying to build a bridge to the post-PC future. Blackberry’s worth has slid to a few billion since it tripped over the very smartphone market it pioneered. Blockbuster has shut down its storefronts and DVD-by-mail services. The death rattles of Radio Shack and JC Penney speak volumes about the challenges in retailing.

This bloodbath isn’t confined to an unfortunate few companies or a particular selection of industries. The threat to established firms is pervasive. Of the names listed in the Fortune 500 in 1955, nearly 87 percent have either gone bankrupt, merged, reverted to private ownership, or lost enough gross revenue to fall off the list. A study of the S&P 500, which ranks companies by market capitalization, found that its constituents averaged 61 years on the list in 1958 but only 18 years in 2012.

Contrast the turmoil in the enterprise world with value creation among the world’s most valuable companies as of December 2013. Apple is worth $500 billion after three and a half decades in business, the beacon of market-disrupting prowess. Google, less than half that age, is valued at $354 billion. Amazon has
a market cap of $180 billion. Facebook’s IPO was a notorious fiasco, but the 10 year old company is still worth $114 billion and rising. Twitter, founded only six years ago, is already worth $22 billion.

Alternatively, consider the fastest-growing companies coming out of the startup crucibles of Silicon Valley and New York. Dropbox, Pinterest, and Uber have expanded to valuations approaching $4 billion in a few short years. Newer arrivals such as Airbnb, Evernote, MobileIron, Pinterest, PureStorage, Marketo, Spotify, SurveyMonkey, Snapchat, Violin Memory, and Zscaler are worth more than $1 billion each. In fact, the number billion-dollar startups is estimated to be in the dozens, possibly as high as 60. These companies are creating value at an unprecedented rate and on a historic scale.

The difference between stagnant enterprises and their fast-growing counterparts is no secret: These emblems of growth have an uncanny ability to bring to market exciting products and services and open vast new markets. High-flying corporations like Amazon and Facebook have proven that big companies can do it. But for lessons in how, the best place to look is startups.

The Golden Age of Startups

If the present is a dark time for established companies, it’s a golden age for new ventures. Entrepreneurs number 380 million worldwide, according to fundersandfounders.com. That number is expected to grow to 1 billion by 2020. Superstar entrepreneurs like Steve Jobs and Mark Zuckerberg have become cultural icons, spawning best-selling books and blockbuster movies. The Social Network, Hollywood’s treatment of the Facebook story, has grossed nearly $1 billion. The Bravo network even took a chance on a reality TV show, Start-Ups: Silicon Valley, that followed a handsome pair of would-be moguls through their efforts to form a business plan and pitch VCs.

All of which has dulled the appeal of even the biggest enterprise brand names. For bright business- and technology-minded college grads, it’s no longer cool to work for a blue-chip corporation. Millennials reject the traditional comforts of man-
agement hierarchy, financial stability, risk aversion, and buttoned-down culture. They want to work at Airbnb, Dropbox, FourSquare, or Tumblr — or launch their own bid to rule the Internet.

And, for the first time, it’s clear how to do it. Over the past decade, what was a wilderness trail to starting a high-growth business has become a well worn path. Students can study entrepreneurship in school, read up on the scene in the startup press, attend meetups for like-minded aspirants, get a job at a hot startup, draw up a business plan, and start pitching VCs.

More important, the cost of starting a company has fallen through the floor. Many fixed costs have evaporated, replaced by variable costs. For instance, Amazon Web Services gives aspiring entrepreneurs access to data center infrastructure, and it costs nothing until customers start showing up en masse. Freelance communities such as Crowdspring, Mechanical Turk, and Elance can handle odd jobs from programming to design to writing press releases. Coworking spaces provide cost-effective offices where startup founders can congregate and support one another until they have sufficient revenue to rent a proper office. Capital has become more accessible as well, thanks to crowdfunding sites such as Kickstarter, online communities like AngelList, and new laws that allow almost anyone to buy and sell equity.

All these trends boost the level of competition with an enterprise’s established business units as well as the possibility that they’ll be blindsided by something unforeseen. A new generation of highly empowered entrepreneurs are coming up fast. They have the means, motive, and opportunity to disrupt your business, and they’re out to do just that.

The Enterprise’s Dilemma

Hidebound enterprises don’t start out that way. As Clayton Christensen pointed out in his classic 1997 business manual, The Innovator’s Dilemma, most large companies begin as innovators who unseat powerful incumbents by leveraging cheap technology to deliver good-enough capabilities at a lower price. The dilemma arises once they’ve ascended to dominance. At this point, they have a market to protect, and their original focus on disruptive innovation shifts to sustaining innovation that bolsters their legacy business. Now exploiting a mature market, they can look forward to lower and lower growth. Ultimately, a new competitor emerges that undermines their business with a cheaper alternative. By failing to develop disruptive technologies first, they leave themselves vulnerable.

Indeed, overcoming inertia has become a do-or-die priority for large organizations. Enterprise CEOs must fend off ever more rapid technological shifts and ever more aggressive competitors. Christensen’s book was the first of what has become a flood of books, conferences, workshops, and blogs devoted to the topic, and executives have embraced them in search of a solution. Corporate innovation has become a rallying cry and a budget line item. Intrapreneurship programs have become commonplace. Internal incubators and accelerators are de rigueur. Corporate venture funds invest millions in emerging markets.
Yet, few enterprises escape the innovator’s dilemma. Instead, they remain mired in the swamp of inertia, lassitude, bureaucracy, and misaligned incentives that afflict virtually every large company.

The key challenge is resource dependence: the fact that organizations rely on external parties for their survival. Securing these resources implicitly becomes the enterprise’s highest priority, regardless of explicit mandates handed down by management. (In the strongest version of this theory, upper-level management has no real control over the company’s priorities; external forces determine the company’s direction.) In other words, enterprises aren’t free to do what they want. Their suppliers, investors, and especially customers exert a magnetic pull toward established lines of business. This tendency to stay on familiar territory is a strong barrier to innovation.

We see this frequently in our work. Would-be enterprise innovators are staring a substantial opportunity in the face but feel compelled to ask themselves, “How does this fit into our business model? Does it suit our brand? Are we good at it?” These questions are deadly to innovation. The company’s values, competencies, and processes are huge advantages in continuing to do what it already does, but they make it nearly impossible to open new territory.

Many enterprise executives try to build an internal culture of innovation. They adorn their offices with ping-pong tables and bowls filled with high-calorie snacks. They move their best and brightest employees into the role of intrapreneur, an internal entrepreneur accorded the freedom to take risks that ordinarily would be frowned upon in the interest of bringing radical new products to market. But most of these efforts come to naught. Intrapreneurs are stymied by politics or side-tracked into low-growth activities. Their most ambitious projects often are wildly misdirected, wasting huge budgets and leaving sterling brands tarnished. Worse, their energy is channeled into me-too products that fail to make a dent in the market. Acquisitions intended to snatch up strategically important technologies or talent suffer from poor integration into the parent company. Bold hires aimed at infusing moribund business units with fresh blood have little effect but to stall promising careers. [It would be great to provide real-world examples of these scenarios.]

**Why Intrapreneurship Fails**

In our view, the word intrapreneur is an oxymoron. The roles of employee and entrepreneur are mutually incompatible. Executives who expect salaried workers transplanted into an innovation department to come up with great ideas, invest the company’s capital in them, and shepherd them to market success are fooling themselves.

Intrapreneurship programs tend to fail for three reasons. First, intrapreneurs aren’t allowed to focus on high-growth opportunities. Instead, they’re forced to address incremental innovations that can lead only to marginal growth. Second, they’re paid a salary. This removes the motivation that drives real entrepreneurs: The
risk of losing everything and the chance of winning a huge payoff. Third, intrapreneurs are distracted by internal politics. Lobbying colleagues doesn’t disrupt industries — innovation does. Let’s take a closer look at each of these factors.

**Autonomy:** The corporate legacy stifles innovative thinking. Sustaining a mature business demands a tight focus on current customers and existing products. Once employees adopt this mindset, it’s nearly impossible to shake. They internalize the company’s values and competencies, which blinds them to potentially industry-changing, high-ROI opportunities that don’t fit the established pattern. Entrepreneurs, on the other hand, rely on being close to emerging trends and new technologies. They spend a lot of time studying the market, playing with products, consulting with other entrepreneurs, sounding out customers, and generally looking for ways to get ahead of the market. They need to be located outside the company’s offices and given freedom to do whatever is necessary to create an independent business.

**Incentive:** Workers don’t take big risks without big incentives, which intrapreneurship programs seldom provide. Employees execute well defined responsibilities in return for agreed-upon wages. It’s a classic arrangement that satisfies the need for certainty on the part of both employer and employee, but it severely dampens the motivation to dream big. Entrepreneurship is about taking big risks in return for the possibility of outsized rewards. This combination of high risk and high reward is immensely motivating. It keeps entrepreneurs going when they encounter seemingly insurmountable obstacles, as they routinely do if they confront market uncertainty head-on. They need to have a personal financial stake in their projects and share in the upside when they succeed, and any enterprise that hopes to benefit from their efforts had better structure their compensation to this effect.

**Focus:** Enterprise innovation departments usually have to fight for funding just like any other business unit. This practice reflects a fundamental misunderstanding of innovation. It takes years to build a successful business, so intrapreneurs are likely to have nothing to show on a semiannual or annual timeline. This state of affairs forces them to play politics to secure their budget. The necessity of garnering internal backing is a dangerous distraction from the task at hand: Discovering products, markets, and business models that can drive significant growth. This sort of diversion leads to development of sub-par products.

Most executives who seek to foster an innovative culture fail to recognize that culture is an outgrowth of organizational structure, incentives, and precedents. A culture can’t be altered in isolation. Changing culture means changing the organization itself and developing a history around the renewed firm. People are inherently creative and entrepreneurial if they’re put in an environment that organizes and incentivizes those qualities.

Until recently, designing such an environment was a tall order. The appropriate structures and processes for innovating repeatably in an enterprise context were theoretical, and by and large the theory didn’t bear out in the real world. Over the past few years, however, the elements have emerged that make it possible create an enterprise environment in which innovation is not a doomed prospect but an automatic outcome. The lean startup movement has proven effective at building viable early-stage ventures at low cost and high speed. Enterprises can adapt lean startup practices to achieve the same results. The discipline of the build-mea-
Sure-learn loop — iteratively building a minimum viable product, experimenting, and making a decision to pivot or persevere — offers process of unprecedented efficiency for building sustainable new businesses.

All the arrows in the lean enterprise quiver are essential, but the tactic known as innovation accounting is especially relevant to established companies. This technique is the key to driving transformation in old-line companies that ordinarily find innovation beyond their grasp. Let’s take a look at how.

**New Tools For CFOs**

The constraints that suffocate innovation in an enterprise setting, from resource dependence to issues of autonomy, compensation, and politics, are largely tied up in the methods that enterprises use to contain costs. This makes good sense: Data accumulated over a long operating history makes it possible to fine-tune margins to squeeze the highest return on investment out of slow-growing and even contracting markets. However, conventional tools of financial analysis are deadly to innovation. Applying methods designed to deal with predictable economics to situations governed by high uncertainty is counterproductive.

For instance, corporate finance officers are familiar with discounted cash flow (DCF) analysis, a technique that discounts future cash flow based on an interest rate to determine the net present value of a business unit. Early-stage companies lack substantial revenue, of course, and it may be unclear how they may monetize, and how their initial revenue strategy may evolve over time. Consequently, discounted cash flow isn’t appropriate to a startup environment. Instead, early-stage companies are valued based on currently invested capital, demand for equity, and intangible factors that might be characterized as buzz. This method is clearly incompatible with what CFOs have been doing for decades.

Innovation accounting is an alternative that makes it possible to measure a startup’s progress toward becoming a sustainable business. Conceived by Eric Ries and introduced in his 2011 book, *The Lean Startup*, this technique involves identifying the metrics of user behavior that have the greatest bearing on growth and building a model that reflects their relationships. Entrepreneurs can begin tracking startup performance literally on day one by entering into the model fictitious numbers that represent an ideal case. Then, as customers arrive, they can plug in real-world numbers and start tuning the business to generate growth. Moreover, as the product changes, they can add numbers that reflect behaviors around these new capabilities to see how they affect the business. The build-measure-learn loop ensures that they validate what they’ve learned and apply it the next time around.

... innovation accounting ... provides an invaluable tool for enterprise CFOs who need to present the results of innovation efforts to stakeholders.
The metrics model fits well with traditional enterprise practices because it's very similar to a DCF. The major difference is that the model is based on user behavior rather than revenue. User behavior may sound like a soft measure compared to cash flow, but for many innovative products, it's the most important. This is because innovative products often require users to adopt a new behavior. Before Facebook, nobody checked their friends' status online; before Twitter, no one wrote public messages in 140 characters. The revenue model for both companies — advertising — is conventional, but the customer behaviors that drive it are unprecedented. If user behavior around this sort of business demonstrates growth, that's the beginning of a viable business.

In this way, innovation accounting allows enterprises to account for the formerly unaccountable. It provides an invaluable tool for enterprise CFOs who need to present the results of innovation efforts to stakeholders. Traditionally, such presentations involve a lot of what Ries calls success theater. This method replaces that with accountability and transparency. CFOs can report growth as reflected in the model, and they can propose valuations based on funding levels of early-stage companies of comparable size and focus gleaned from information sources such as AngelList and CrunchBase. This is a powerful way for CEOs to communicate an innovation portfolio's progress and what it means to the company. It provides a rational case for innovation within the enterprise.

Innovative companies gain fringe benefits as well. Being perceived as a leader generates a halo effect that can improve morale throughout the corporation. This can be a boon to employee retention and recruiting. Establishing an entrepreneurial path within the enterprise attracts not only internal candidates who have ambitions beyond their current job but also outside talent that appreciates the strengths an established company can bring to a new venture. They can live the dream in a more comfortable and stable environment.

And the impact extends well beyond the company's walls. Today, people who feel an entrepreneurial urge must choose between holding a conventional job and putting their livelihood on the line, subsisting on ramen, and sleeping on the couches of indulgent friends. The lean enterprise offers a third way: They can share the risk with an organization that has been architected to maximize their chance of success. This approach provides a path for would-be entrepreneurs who don't have the means or personality to found a start-up on their own, but who may have valuable ideas, talents, and skills. It makes far more efficient use of the entrepreneurial spirit that permeate society at large.

Every company must face the reality that the departure of a single employee can cost the company billions in lost opportunity. There's a better way: Put entrepreneurs in a special environment that enables the autonomy, incentive, and focus required to innovate. The remainder of this book will illuminate the path.

**The Innovation Opportunity**

Enterprises are in a tough bind, but the lean enterprise approach offers powerful new tools that can turn companies focused on protecting old markets into masters of discovering and mining new ones.
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