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# ORGANIZATION CAPABILITY: THE MISSING PIECE CONNECTING ORGANIZATION DESIGN AND THE OPERATING MODEL

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## Organization capability:

### The missing piece connecting organization design and the operating model

#### INTRODUCTION

Successful strategy execution requires complete alignment of people and processes throughout the organization. Properly defining the operating model and designing the organization the right way are essential foundations for strategy success. Yet a main reason execution fails is lack of attention to and integration of a third essential component of systems design: organization capability.

The operating model, organization design and organizational capability are the three building blocks of successful strategy execution. Leaders of organizations worldwide talk about all three constantly. Yet despite the enormous time spent citing them, there is more than a little confusion regarding how they are distinct, and how they best should be leveraged and integrated with each other. The end result: derailed execution efforts.

Of the three, organization capability has received the least attention and development. What's missing is a robust framework and tight linkages back to the operating model and organization design. This article lays a foundation for addressing those gaps, and for drawing boundaries between the operating model, organization design and organization capability.

#### The key takeaway

Classic organization design models are strong in upfront specification of the structure of decision making and work, but weak on the details of process and reward optimization. In both Jay Galbraith's Star Model and McKinsey's 7S, management and work processes, and rewards, play central roles. Yet both these workhorses of organization design fall short on distinguishing between what can be designed effectively upfront, and what has to be worked out after the (re)design is launched and the work is underway.

The source of the problem is that process and reward *design* are quite different than process and reward *optimization*. The design phase comes first. Optimization only happens much later, as the designs are put in practice, people learn how to do the work together in new ways, and subsequent adjustments are

made to many parts of the system design, as needed: roles and responsibilities, KPIs, work processes, management processes, performance management, feedback, etc. The operating model and organization design by necessity focus on the process and rewards design phase. Yet because they emphasize the upfront design, they fall short on process and reward optimization precisely because they are done at the outset, before the work starts, and before all the shortcomings with the design are discovered. The challenge of optimizing processes and rewards is then left to organizational capability.

### **RESOLVING CONFUSION ABOUT ORG DESIGN, THE OP MODEL AND ORG CAPABILITY**

Organizational capability has to fill the gap of optimizing processes and rewards while the work is taking place. Effective organization capability means processes and rewards work well, and are mutually reinforcing. And that can only happen once a great deal of learning about the new ways of working has happened.

#### **Why is there confusion in the first place about organization design, the operating model, and organization capability?**

Of the three, organization design is the most well-defined (Jay Galbraith's Star Model, McKinsey's 7S, etc.) For the operating model and organizational capability, in contrast, there are no leading models or well-defined frameworks that are commonly accepted. They also are much more recently used terms. If you do a Google search for either term, the most widely cited articles or web pages are offerings from consulting companies in the past 20 years. What's missing in both cases is a succinct definition that can help guide decision making, and a way of integrating both with the organization design.

The specific challenges are different for the operating model and for organizational capability.

*Challenges with the operating model.* There are many examples of defined operating models for specific organizations, with each organization creating its own. These often take the form of graphical depictions of the company's activities which need to be executed effectively, providing a high-level view of the business' core processes. Yet precisely because they are graphical and high level, they lack the details needed to understand how each process works in practice, and how to overcome the challenges of competing strategic and operational objectives. For example, Shell's operating model (<https://reports.shell.com/annual-report/2020/strategic-report/strategy-business-and-market-overview/our-business-model-explained.php>) specifies the main activities and processes of upstream

production and downstream delivery of oil and gas with no details on what happens in practice day-to-day.

Even more confusing, in most large organizations, each business unit and function often talks about their own “operating model” as if the term means the same thing for the entire enterprise as it does for the subparts. Yet the core processes of the business model at the enterprise level are much broader than for any one business unit. And each function’s operating model by definition is going to be about the function itself more than the enterprise as a whole.

*Challenges with organizational capability.* The situation with organizational capability is not any better. Leaders often call out the capabilities needed for successful strategy execution, while assuming what is meant by “capabilities” is clear. We personally have worked with a number of leading global companies that have attempted to do a rigorous exercise around building and improving their organizational capabilities. They can usually identify high-level concepts such as quality, go-to-market efficiency, innovation, etc. Yet translating those high-level concepts into the details needed to bring the capability to life usually runs into substantial challenges. What’s missing is a clear framework for defining and building the capabilities.

To bridge that gap, we start with defining the scope and details for the operating model and organization design. From there we will show how organizational capabilities, properly defined and implemented, can be the missing pieces that bring the organizational system into alignment.

There is no “defined playbook” for which comes first. However, in practice, the order most organizations follow is (a) first define the operating model based on the strategy and business model, then (b) do the organization design, followed by (c) build the organization capability needed to implement the operating model and organization design.

## STRENGTHS AND WEAKNESSES OF THE OPERATING MODEL AND ORGANIZATION DESIGN

### Operating model

The operating model defines the framework and components that an organization uses to operate and deliver value. The operating model defines, at a high level, conceptually how an organization's resources, processes and activities are organized, coordinated and aligned to execute the strategy.

| <b>Strengths</b><br><b>A well-defined operating model:</b>   | <b>Weaknesses</b><br><b>Because the operating model focuses on higher-level design criteria:</b>  |
|--|---|
| Provides a set of guiding principles – design criteria – for the organization design and organizational capability, so we know what we're supposed to be aiming for. | There are few to no details on how it is supposed to work in practice.  |
| Provides a clear statement of the core activities that are essential for successful strategy execution.  | It is more focused on storytelling than resolving conflicts that arise from the organization design (e.g. centralized versus decentralized decision making) and conflicting business priorities (e.g. faster, better, cheaper). |

Many of the weaknesses of the operating model are left to be addressed by the organization design.

### Organization design

The organization design addresses how the organization is structured, including roles, responsibilities reporting lines, and other formal relationships. It establishes the hierarchy, division of labor, and coordination mechanisms, including lateral-integrating structures (functions; teams) and processes.

| <b>Strengths</b>   | <b>Weaknesses</b>  |
|--|--|
| The organization design directly addresses the challenges of designing a complex system with competing priorities and lots of moving parts.  | All the main design decisions have to be made up front so there is clarity in who is responsible for what, and how conflicts are supposed to be resolved. This all has to be specified before the work starts and we learn the strengths and weaknesses of the organization design. Conflicts that arise in the operating model can be easier to address quickly than conflicts in the organization design, since the former is more conceptual and high-level, while the latter is more structural and based much more on defined rules, roles and responsibilities.  |
| Key issues addressed include: <ul style="list-style-type: none"> <li>• Potential conflicts in decision making, via the organizational chart and matrix reporting relationships.</li> <li>• Tensions between business processes and rewards: what can be more easily measured and people can be held accountable for, versus what's important but much harder to measure and respond to in a timely fashion.</li> </ul> | Processes cannot be perfectly designed ahead of time, and have to be ironed out and optimized while the work is taking place. In practice, processes need to be an intricate part of each of the three pieces: operating model, organization design, and organization capability. Which means process design, piloting, rollout, scaling, and optimizing are related to all three. Yet process maturity only happens over time, and can never be accurately predicted in terms of all the twists, turns and unexpected challenges. Which is why processes cannot be perfected at the initial organization design stage.  |
| The organization design directly addresses the first shortcoming of the operating model, providing many of the missing details on how the operating model is supposed to work in practice.   | Rewards can be designed in principle, but there are big limits on how to use formal rewards systems to encourage and enable the desired behaviors at the individual level, team level, business process level, and enterprise-wide. The formal rewards have to be coupled with informal rewards, culture, leadership behaviors, etc. to create a cohesive system that reinforces the design criteria of the operating model and organization design.   |
|  | There rarely are good real-time measurements or KPIs for most of what we want to know about individual behaviors and how they contribute to team and business unit performance. Only after the fact can we sometimes tell if work was done the right way for the right reasons. This is a version of the classic economics or game theory principal-agent problem: the organization (or leader) needs the staff to behave in certain ways but cannot just compel them to do so. No amount of before-the-fact engineering of the organization design can solve these challenges or make them go away. They have to be addressed in real time, or after the fact, which makes alignment quite difficult. |

## CHALLENGES OF SYSTEM DESIGN AND OPTIMIZATION

The limitations of the organization design are one example of the more general problem of system design and optimization. You can't perfectly design all parts of a system at the outset: because systems are complex, dynamic and messy. It is too hard to figure out all the details up front because we can't predict all the conditions ahead of time. So the design and optimization have to be addressed sequentially: design upfront, followed by optimization afterwards, while the work is underway. A robust optimization process should include ongoing sensing and a thoughtful approach to tweaking each component: the operating model, organization design, and organization capability.

When designing an organizational system:

- You can't perfectly design everything all at once. Thus
- You need to start with the design criteria that are most important and get those right before moving onto the other parts of the system.
- Setting the design criteria for the superordinate goals has knock-on effects on the options for designing the other parts of the system. The knock-on effects are revealed only after the work is underway.
- Once you learn about the knock-on effects, you usually have to revisit the superordinate goals and make adjustments to the original organization design to ensure the design is achieving the intended objectives (KPIs) required by the strategy and operating model. In some cases, the original design itself may need to be substantially altered.

The role of organizational (or system) design versus what happens in practice is a lot like the first step in designing a building. The architect creates the blueprint, which is just like the organization design. Once the blueprint is created, the contractor has to build it, and an interior designer has to figure out how to make everything work within the structure.

The architect will specify a lot of details which often turn out to be off the mark. Some of the architect's design decisions will be inaccurate because conditions in the real world of construction are never as simple and clear cut as the blueprints assume they will be. There could be shortages of certain materials or their prices end up increasing beyond the originally planned budget, necessitating changes.

The architect also has to make assumptions about the conditions at the building site, which have to be verified and, if needed, adjusted by the engineer. For example, the soil conditions might require a different approach to shoring up the foundation of the building, which in turn changes some of the structure's design elements. So it is impossible to know what all the details of the final structure will be until after it is built under real world conditions. This is why the architectural building blueprint is analogous to the organization design, including details about high-level decision rights, matrix design, and lateral integrating structures.

The other source of uncertainty is that architects cannot fully know ahead of time exactly how the people would prefer to use the space. Once the shell of the building is complete, only then can final design decisions be made. What are the limitations of each part of the building, in terms of the range of uses they can be put to? For example, the plumbing may have to be routed differently than originally designed, changing the location of bathrooms, kitchens and dining areas. Where should all the walls be located exactly? To what use will each room be put? Will there be a closet added within a room? Do some rooms require greater sound proofing in the walls, floor and ceiling? Where are reinforcements in the walls and ceiling needed to secure built-in cabinetry and heavier lighting fixtures or electronic equipment? These are all decisions that can't be specified completely ahead of time, and which are addressed once the basic structure is built.

After the blueprint is set at the outset, the interior designer and contractor optimize the design created by the architect, once the initial structure is in place. The equivalent work in organizations is everything that follows the design of the high-level decision rights, matrix design and lateral integrating structures: getting it all to work together as seamlessly as possible in practice. Which means spending a lot of time and effort on work processes and rewards.

### **ORGANIZATIONAL CAPABILITY DEFINITION, STRENGTHS AND WEAKNESSES**

Organizational capability provides the missing pieces of the puzzle not sufficiently addressed by the organization design and operating model. This includes the collective skills, knowledge, abilities, and resources within an organization that enable it to perform its functions and achieve its objectives. It encompasses the competencies, capacities and expertise of individuals, teams, functions, departments, units, and the organization as a whole. Organization capability is not simply the aggregation of individual



skills or competencies. Rather, it is the outcome of complex system design and optimization that is built on both individual and team- or group-level dynamics and contributions to organizational performance.

People often conceive of organizational capabilities as what is built or is embodied within people, teams, etc. But capability is not static. Just as individual competencies are a combination of KSAs (knowledge, skills & abilities) and behaviors, organizational capabilities are also dynamic and depend on people doing the right thing, at the right time, for the right reasons. We deem someone “competent” when they not only *can* perform the way we expect, but that they actually *do* perform as expected. Similarly, we consider an organization to have a particular capability – speed, quality, innovation, etc. – only if it exhibits the capability in line with market expectations, not based on its potential.

Because of this, core elements of organizational capability include not just the enterprise-level equivalents of KSAs, but also actual performance. And the bridge that gets an organization from potential to actual performance includes essential managerial processes and decision making such as goal setting, holding people accountable for doing what they need to do, and rewarding everyone – individuals through entire business units – for doing the work the right way so the desired results are achieved. Processes have to be designed and executed as intended, and rewards – both formal and informal – have to be designed and applied to ensure the processes are done the right way.

Ultimately, organizational capability depends on people – everyone from frontline staff through the CEO – doing their jobs fully aligned with the strategy and operating model. The devil is in the details. And there are too many details and contingencies that cannot be forecast and decided ahead of time.

Process and reward optimization is extremely difficult, and takes as much energy and attention as the upfront operating model and organization design work. Yet the optimization happens under highly constrained conditions. Once the upfront design is done, senior leaders switch their mindset from exploration to execution mode, assuming all design decisions are done. In their view, with all the new reporting lines defined, budgets set, and roles and responsibilities determined for all key processes, the most important objective is putting everything into place. They are willing to accept that some tweaks might be needed, yet they put the organization into a defensive position, where people need to “prove” that any changes are warranted.

If you take the perspective that the upfront design is the best possible, that people do not like change (which they do not, of course), and that many people may be legitimately skeptical about the changes, then it is reasonable to singularly focus on executing the upfront design, figuring that people just need time to figure out how to make it all work. Yet that mindset is exactly what leads to many problems with strategy execution: any information that crops up about problems with the design is downplayed if not outright dismissed by leaders who want their people to take enough time to try to make things work out.

The answer is that the development and refinement of organization capabilities, and any adjustments needed to the operating model and organization design, have to be conducted after the work is underway. Thus there is no clear dividing line between the upfront initial system design, and the subsequent execution and learning phases. Depending on what happens during the execution and learning phases, immediate adjustments are often needed in the upfront design. Which means that the upfront design needs to be treated more like a set of guidelines or guardrails in which there is substantial flexibility, rather than a set of blueprints to be followed exactly without question.

| <b>Table 3: Organization capability strengths and weaknesses</b>  |  |
|---|--|
| <b>Strengths</b>  | <b>Weaknesses</b>  |
| The yin to the organization design's yang: the two are necessary complements to each other.   | Focusing on capability alone, without regard for the existing organization design, can lead to too-narrow diagnoses and imperfect solutions to improving performance.  |
| Solves the problems created by the shortcomings in the organization design.   | Many sources of problems can be traced back to the organization design, and must be acknowledged. Structural challenges cannot be overcome solely through managerial process improvement and executing within the upfront design.  |
| Addresses the weaknesses in trying to design a system perfectly upfront.  | The desired objectives and KPIs may never be attainable, especially given the conflicting and competing nature of most corporate strategic objectives (better, cheaper AND faster). Focusing on how people are held accountable and rewarded for unrealistic KPIs that are baked into the strategy cannot solve the foundation of the problem.   |
| Solutions are tailored to how the work needs to happen to be successful.  | On the flip side, because there is so much complexity in the system, and people are independent operators, not machines, it may be impossible to determine beyond a shadow of a doubt whether it's the KPIs that are unattainable, or the people and processes in the system that get in the way of attaining the KPIs. So there is a tradeoff between holding people accountable for implementing the upfront design, emphasizing execution, and providing oft-needed leeway to make quick, real-time adjustments, emphasizing learning and adaptability of the upfront design decisions. |
| Addresses gaps created by: <ul style="list-style-type: none"> <li>o Siloes</li> <li>o Shared decision making / matrix designs</li> <li>o Challenges of coordinating work across many different units and functions</li> <li>o Getting diverse teams to work together effectively</li> <li>o Shortcomings in performance management systems and processes</li> <li>o Etc.</li> </ul> |  |

## PUTTING IT ALL TOGETHER: ORGANIZATION DESIGN AND CAPABILITY

A detailed comparison of what happens at the upfront organization design phase versus during the organization capability phase as the work is underway is way more than can be covered in this brief series. The following provides a high-level comparison of some of the more important elements:

| <b>Table 4: Organization design and capability</b>  |  |
|---|--|
| <b>Organization design blueprint</b>  | <b>Organization capability counterparts</b>  |
| <b>High level decisions about products, services and business processes:</b> What are we going to produce and how should it be done.                                    | <b>Process performance:</b> Where are there issues in meeting conflicting or overly aggressive operational and strategic goals?  |
| <b>Decision rights:</b> the organization chart, including matrix reporting  | <b>Decision making:</b> When conflicts arise, which ones are not addressed quickly and correctly?  |
| <b>Process mapping all the steps needed:</b> who plays what roles at each step, and who has responsibility for making sure things are supposed to happen the right way. | <b>End-to-end process execution:</b> Where do things go as planned, and where do they deviate from the blueprint?  |
| <b>KPIs:</b> goal setting + what we are supposed to hold people accountable for   | <b>KPIs:</b> Where are we meeting them versus falling short?   |
| <b>Formal rewards:</b> how are people are going to be paid, including bonuses   | <b>Informal + formal rewards:</b> How are things playing out in practice? Where do we struggle to hold people accountable because of interdependencies in work across roles, within teams, and across units. |

There is no single path every organization should take to developing robust organization capabilities and aligning them with the operating model and organization design. The most important things to keep in mind are the following:

- Faster, better, cheaper can never achieved as expected. The new capabilities almost certainly will take more time (slower), and require more resources (more expensive) to develop capabilities that can only be perfected over fairly long time horizons (lower quality, at least in the short term).
- To improve performance along all dimensions (faster, cheaper and better), the senior executive team will have to stay much more closely involved than they are used to doing, and how they would like to operate.
- Despite senior leaders having to stay closely involved, it needs to be “light touch” so that the people underneath them in the org chart have the time and space to figure out how to do the work without micromanagement from above.

- Senior leaders need to ensure that team members preserve the ability to quickly engage upper management so real-time decisions can be made about tweaks to the operating model and organization design as new information is learned about how best to do the new work.
- Senior leaders need to be aligned among themselves and follow through on dynamic budgeting and headcount allocations so any needed shifts in the operating model and organization design can be executed as quickly as possible.

Ultimately, what often makes the difference between designs that work versus those that fall short comes down to how flexible senior leaders are in their approach to ongoing learning and adjustments to the design. The usual tendency is to treat the initial design as “set in stone” (or concrete), which “just” has to be implemented before any alterations can be considered. Yet that approach leaves scant room for flexibility and learning because there is little tolerance for criticism of the initial design.

Success ultimately depends not just on which design is implemented but also the change management that is an integral part of the roll out. Successful design implementations usually are rolled out using a more collaborative process of developing and refining the design, with pilot tests and ongoing refinement as people learn about how to structure the work and iron out the kinks of the new processes.

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