Excellence in Financial Management

All Discussion Board Articles

Written by: Matt H. Evans, CPA, CMA, CFM

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Table of Contents

Cash Flow Management

Basic Cash Flow Management

Managing cash must take an equal stature with Net Income. In financial management, "cash is king" is a frequent motto. Your first step in managing cash is to elevate the importance of cash. The basic process for managing cash is straightforward. Try to maintain an adequate level of cash to meet current obligations and invest idle cash into earning assets. Earning assets must have high liquidity; i.e. you must be able to convert investments back into cash quickly. Additionally, you want to protect your cash balance by paying obligations only as they come due.

Managing cash also involves aggressive conversion of current assets into cash. Inventory levels must be converted into accounts receivables and accounts receivables must be converted into cash. Ratios should be used to monitor the conversion of cash, such as number of days in inventory and number of days in receivables. Cash balances are the result from a combination of cycles: inventory, purchasing, receivables, payables, etc. The key is to properly manage these cycles for conversion into cash.

Once conversion cycles are identified, cash forecasts can be prepared for managing cash. Weekly cash reports are used to monitor balances. Since everything ultimately passes through your cash account, a strong internal control system is required. This involves the separation of duties in handling cash, reconciling cash accounts, adequate support for cash disbursements, and other control procedures. The overall objective is to protect cash just like any other asset through a system of internal controls.

Quick Tips for Improving Cash Flow

The first step for improving your cash flow is to understand the history of your cash flow. This requires scheduling cash inflows and outflows. Once you understand the history, you can take steps to cut cash outflows and increase collections.

One of the biggest cash outflows is payroll. Payroll should be managed with flexibility in mind. You need a workforce that works when needed as opposed to 5 days a week, 8 hours a day. Consider diversifying your work force into a mix of temporary workers, part-time workers, and outsourcing of non-value added activities. Also, don't forget you can extend your payroll float by distributing payroll checks after 2:00 o'clock on Fridays.

Your purchasing practices should also consider a mixed approach. For example, why do you have to buy everything new? Purchasing used items or renting can save a lot of cash flow. You may want to purchase in minimum quantities, especially if your cash flow is tight. And do not hold inventory that isn't moving - get rid of it!

Other cash traps include insurance. Do not use insurance to cover all risks. Make sure you retain some risks, especially if the risk is not materially significant and not likely to occur very often. One of the fastest rising insurance outflows is health care costs. Make sure you have a preventive program for your employees. This can include things like annual cholesterol screenings, reimbursement for quit smoking programs, and company participation in outdoor activities. Finally, aggressively monitor your outstanding receivables and begin to take action at the first sign of trouble. If you have doubts about a customer's ability to pay, require an advance deposit.

Cash Support for Sales Growth

As sales grow, cash needs will grow. Planning for future sales must include planning for additional requirements for cash. A basic formula can be used to help determine the amount of additional cash needed for new sales. The formula is calculated as follows:

Additional Cash = ((New Sales - Gross Profit) + Additional Overhead) / (Sales Growth Duration in Days x Average number of days to collect Receivables + Safety Factor)

Example: We expect $ 10,000 of additional sales during the year (365 days) with a corresponding increase of $ 3,000 in overhead. All payables are paid on time, we do not expect any changes in our collection periods, and we expect a continued gross profit margin of 25%. The average period to collect receivables is 40 days and we will add in a safety factor of 20% into our estimate.

($ 10,000 - $ 2,500) + $ 3,000 / 365 = $ 28.77 x (40 x 1.20) = $ 1,381 of additional cash is needed to support the $ 10,000 of additional sales.

The above formula is a quick and rough estimate for estimating how much cash is needed to carry additional sales. Changes in collections and payment cycles need to be considered when using this formula.

Basic Accounts Receivable Management

This article will outline some of the basic components for managing accounts receivable, ranging from policies and measurement to outsourcing options.

The foundation behind account receivables is your policies and procedures for sales. For example, do you have a credit policy? When and how do you evaluate a customer for credit? If you look at past payment histories, you should be able to ascertain who should get credit and who shouldn't. Additionally, you need to establish sales terms. For example, is it beneficial to offer discounts to speed-up cash collections? What is the industry standard for sales terms? There are several questions that have to be answered in building the foundation for managing accounts receivables.

A system must be in place to track accounts receivables. This will include balance forwards, listing of all open invoices, and generation of monthly statements to customers. An aging of receivables will be used to collect overdue accounts. You must act quickly to collect overdue accounts. Start by making phone calls followed by letters to upper-level managers for the Customer. Try to negotiate settlement payments, such as installments or asset donations. If your collection efforts fail, you may want to use a collection agency.

Also remember that the collection process is the art of knowing the customer. A psychological understanding of the customer gives you insights into what buttons to push in collecting the account. One of the biggest mistakes made in the collection process is a "sticks only" approach. For some customers, using a carrot can work wonders in collecting the overdue account. For example, in one case the company mailed a set of football tickets to a customer with a friendly note and within weeks, they received full payment of the outstanding account.

Measurement is another component within account receivable management. Traditional ratios, such as turnover will measure how many times you were able to convert receivables over into cash.

Example: Monthly sales were $ 50,000, the beginning monthly balance for receivables was $ 70,000 and the ending monthly balance was $ 90,000. The turnover ratio is:
.625 ($ 50,000 / (($70,000 + $ 90,000)/2)). Annual turnover is .625 x 360 / 30 or 7.5 times. If you divide 360 (bankers year) by 7.5, you get 48 days on average to collect your account receivables. You can also measure your investment in receivables. This calculation is based on the number of days it takes you to collect receivables and the amount of credit sales.

Example: Annual credit sales are $ 100,000. Your invoice terms are net 30 days. On average, most accounts are 13 days past due. Your investment in accounts receivable is:

(30 + 13) / 365 x $ 100,000 or $ 11,781.

Example: Average monthly sales are $ 10,000. On average, accounts receivable are paid 60 days after the sales date. The product costs are 50% of sales and inventory-carrying costs are 10% of sales. Your investment in accounts receivable is:
2 months x $ 10,000 = $ 20,000 of sales x .60 = $ 18,000.

Measurements may need to be modified to account for wide fluctuations within the sales cycle. The use of weights can help ensure comparable measurements.

Example: Weighted Average Days to Pay = Sum of ((Date Paid - Due Date) x Amount Paid) / Total Payments

Example: Best Possible Days Outstanding = (Current A/R x # of Days in Period) / Credit Sales for Period

Receivable Management also involves the use of specialist. After-all, you need to spend most of your time trying to lower your losses and not trying to collect overdue accounts. A wide range of specialist can help:

- Credit Bureau services to review and approve new customers.
- Deduction and collection agencies
- Complete management of billings and collections

Examples of specialist include www.clect.net , www.ecredit.com , and www.iab-inc.com . Finally, don't overlook software programs for managing receivables, such as www.getpaid.com .

Financing

What are Effective Interest Rates?

The effective interest rates you pay are a function of how much money you have available and how much money you give up for the use of these funds. In the simplest form of borrowing, a one-year loan of $ 10,000 at 12% interest will costs $ 1,200. The effective interest rate is $ 1,200 / $ 10,000 or 12%. As we change the costs and/or amount of funds available, the effective interest rate will change.

Example: You borrow $ 10,000 at 12% which is discounted by the Bank at 10%, thereby reducing the amount of funds you have available. The effective interest rate is:
$ 1,200 / $ 9,000 or 13.3%.

Compensating balances also decrease the proceeds of the loan. As proceeds decline, the effective interest rate rises.

Example: You borrow $ 30,000 at 12%. The Bank requires that you maintain a 10% compensating balance. The effective interest rate is:
$ 3,600 / ($ 30,000 - $ 3,000) = 13.3%.

The Cost of Financing Inventories

Inventory financing can be used where inventories are highly marketable and no threat of obsolescence exists. The inventory serves as collateral within the financing arrangement. Financing can occur up to 70% of inventory values provided that inventory prices are relatively stable. The costs of financing inventory can be very high; such as 6% over the prime lending rate.

Three types of financing arrangements for inventory are available. They are floating liens, warehouse receipts, and trust receipts. Floating liens place a lien on the overall inventory stock. Warehouse receipts give the lender an interest in your inventory. And trust receipts represent a loan which is released as you sell your inventory. The costs of financing inventory is illustrated in the following example:

You would like to finance $ 100,000 of your inventory. You need the funds for 3 months. You will use a warehouse receipt arrangement. This arrangement requires that you setup a separate area for the lender's inventory. You estimate an additional $ 2,000 in costs for storing and maintaining the inventory. The lender will advance you 80% at 16%. The costs of financing inventory is $ 5,200 as calculated below:
.16 x .80 x $ 100,000 x 3/12 = $ 3,200 + $ 2,000 or $ 5,200.

What is Operating Leverage?

The use of fixed assets in generating earnings is referred to as operating leverage. Operating Leverage is measured by comparing the change in profits to the change in sales. Higher levels of operating leverage tend to result in wider variations in profits given a change in sales. This variation is called operating risks. Therefore, higher levels of fixed costs are often associated with high levels of operating risks which in turn leads to fluctuations of earnings given a change in sales.

Breakeven analysis is often used in conjunction with operating leverage. As we increase sales beyond the breakeven point, the effects of operating leverage diminish since the sales base we are using has increased. We can use breakeven analysis to calculate operating leverage.

Degree of Operating Leverage (DOL) = % Change in EBIT / % Change in Sales
EXAMPLE: Price of Product = $ 10.00, Variable Cost per unit = $ 6.00, Fixed Costs = $ 12,000 and 5,000 units are sold.

DOL = (($ 10.00 - $ 6.00) x 5,000) / ((($ 10.00 - $ 6.00) x 5,000) - $ 12,000) = 2.5

What we can conclude from our calculation is that when sales increase by say 10%, we can expect a 25% increase in earnings since we have operating leverage of 2.5. Thus, operating leverage gives us some measure of variations in earnings from changes to sales.

What is Zero Working Capital?

Working capital is the comparison of current assets to current liabilities. For most organizations, current assets exceed current liabilities and working capital therefore represents the liquid reserves for meeting current obligations. Creditors prefer high levels of working capital since they are concerned about receiving payment. However, management prefers low levels of working capital since working capital earns an extremely low rate of return. Some companies are now driving working capital to record low levels, so-called Zero Working Capital. By keeping working capital at zero, funds are released for many other opportunities.

Zero Working Capital requires major changes in how an organization functions. One way to implement Zero Working Capital is to have a demand-based organization. Demand-based organizations do everything only as they are demanded: Fill customer orders, receive supplies, manufacture products, and other functions are done only as needed. The production facilities run 24 hours a day non-stop according to the demands within the marketplace. There are no inventories; everything is supplied immediately as needed. The end result of this demand driven organization is that little, if any, working capital is necessary to run the business.

Companies like GE (General Electric) and Campbell Soup have made Zero Working Capital a major strategic objective for the organization. As more and more businesses find faster ways of servicing customers, the concept of Zero Working Capital will become more mainstream.

The IPO Process

For private companies in the United States, the first issue of securities to the public is referred to as an Initial Public Offering (IPO). IPO's are extremely speculative and rarely do they result in large gains for investors. However, since capital is often needed to grow a private company and values of companies are best determined in the marketplace, IPO's continue to be used as a way for growing private companies.

Currently, IPO's are one of the hottest topics in financial management. Behind the glamour and the glitz of Initial Public Offerings (IPO's) there is a tremendous amount of hard work and personal sacrifice. IPO's require a core group of highly skilled professionals who must literally work around-the-clock for one year. Therefore, one of the first steps to a successful IPO is the formation of a seasoned, experienced team of professionals who will make the IPO happen. You must recruit the best possible people you can find - there is no time to supervise inexperienced MBA's fresh out-of-school.

Once an IPO team (Investment Banker, Legal Council, SEC Expert, Outside Auditor, etc.) has been formed, you can establish a plan for the IPO Process. A basic timeline for an IPO will usually consist of:

Month 12: Recruit new management to run the public company - CEO, CFO, etc. Start compiling the financial information.

Month 11: Start due diligence work - worthless assets are written off, inconsistencies with GAAP are resolved, etc.

Month 10: Start drafting the prospectus. Coordinate the collection of data to minimize duplicative efforts.

Month 9: Establish a board of directors for the newly formed public company.

Month 8: Draft three-year historical financial statements.

Month 7: Circulate draft prospectus for comments.

Month 6: Establish transition contracts for services and products that will now be provided to the newly formed public company. Some new contracts will be needed, such as independent audits of financial statements.

Month 5: Finalize historical financial statements. Start preparing interim (stub) financial statements for current period.

Month 4: Finalize pro forma and interim financial statements. Make revisions to draft prospectus.

Month 3: Convene new board of directors. Audit of interim financials should be complete.

Month 2: Outside auditors opinion is issued. Membership with stock exchange is complete.

Month 1: File prospectus with SEC (Securities Exchange Commission). Issue press release and sell the company to investors.

Before the IPO Process is complete, it is essential to implement all of the necessary controls, procedures, and systems that will now be required within "public life." Staff changes must be made, new financial systems tested, functions like human resources must be managed, etc. The entire IPO process is much more involved than most people realize. A great IPO team and proper planning are the key to a smooth IPO process.

Before considering an IPO, remember some of the key disadvantages. Once public, your company will be operating in a fish tank, much more visible to outsiders. This will require servicing investors, the SEC, and other interested parties. And don't forget you will have to pay at least $ 500,000 per year in accounting and director liability insurance fees. Going public has got to fit with your strategic plan for growth if you expect the benefits to outweigh the costs. Don't overlook the single biggest source of money, investments made by other companies in emerging, high-growth companies. For many companies, the IPO process is a grueling and wrenching process that fails to meet expectations. Planning well in advance is the key to a successful IPO.

Budgeting & Forecasting

Financial Forecasting Using % of Sales

Financial forecasting often begins with a forecast of future sales. The Sales Forecast serves as the basis for estimating future expenses, assets, and liabilities. Many of these accounts vary with changes in sales. Therefore, using a percent (%) of sales can be very useful for forecasting a Balance Sheet.

The following steps can be used to prepare a forecasted (pro-forma) Balance Sheet based on the % of Sales Method:

1. Determine which Balance Sheet accounts vary with Sales (such as accounts receivable). Calculate the % of sales for each account that varies with sales.

2. For accounts that do not vary with sales (such as long-term debt and equity), simply list the current balances from the last Balance Sheet.

3. Calculate the future Retained Earnings balance by adding projected net income and subtracting any future dividends from the Beginning Balance for Retained Earnings. Don't forget to calculate a % of sales for Net Income and Dividends.

4. Add up your assets to determine total projected assets. Now add up your liabilities and equity to determine the financing of assets. If total assets are greater than total liabilities and equity, then you will need to raise additional capital.

Please note that the % of Sales Method is based on the assumption that you are operating at full capacity. Also, you will need to prepare a Cash Budget for a more accurate estimate of financing requirements.

Improving the Budgeting Process

One of the most non-value-added activities within financial management is budgeting. Budgets are prepared to allocate and control how resources will be used in the future. Unfortunately, the future is hard to predict and upper-level management doesn't always communicate with people who prepare budgets. Because of poor communication, budgeting becomes an exercise in futility. Some of the main problems associated with budgeting are:

- Poor communication from decision-makers.
- Too many people involved in the process.
- Budgets don't help manage our business.

- Budgets are outdated by external events.
- Budgets are difficult to revise.

Since upper-level management often circumvents the budgeting process, the first thing to do in budgeting is to find out *what does management expect from the budgeting process*? Next, make sure management decision making is linked to the budgets. You can accomplish this by creating budgets within the strategic planning process. Don't forget to include external factors when preparing budgets. Outside events and issues can impact your budget estimates.

Budgets should be easy to revise. When new planning data pops up, your budgeting process should adopt and accept this new data. Hold you're cost centers responsible for meeting their budgets. This can force feedback from end-users for improvements in the budgeting process. If you find yourself always revising a budget, consider preparing several budgets or setup a contingency budget if you expect changes. Prepare the basic outline or summary of a budget and get approval before you spend lots of time preparing detail budgets. Or better yet, try to reduce the detail in your budgets to streamline the entire process.

Budgeting should be a dynamic process within strategic planning. The more your budgets can react to change, the closer budgeting will be to a value-added activity. If your budgets don't add value to decision making, than it's time to improve the process.

Don't Forget to Use Expected Values in Your Forecasting!

There are many turns and twists when it comes to forecasting cash flows and other amounts. The last thing you need in your analysis is statistical errors that distort your estimates. The problem is what amount do I use? Do I use the average amount? Do I use the most likely amount? Or do I use the expected value?

In order to come up with a realistic estimate of what amount will occur in the future, you should use expected value. Expected value is not the same as average value or most likely value. Expected value is derived by looking at all possibilities and taking into account the probability of occurrence. Using expected value has statistical merit over other approaches since you are forced to give consideration to all possible outcomes. And the difference you get in estimates can be extremely significant.

Let's say you need to estimate the cash inflows for next month. You have three customers who have outstanding receivable balances. Based on past histories, you can assign probabilities to receiving payment next month.

Customer A owes $ 10,000, there is a 60% probability of receiving payment next month. Customer B owes $ 20,000, there is a 30% probability of receiving payment next month.

Customer C owes $ 30,000, there is a 10% probability of receiving payment next month.

Total Expected Value next month = ($10,000 x .60) + ($20,000 x .30) + ($30,000 x .10) = $ 15,000. Total Average Value = ($10,000 + $20,000 + $30,000) / 3 = $ 20,000.
Total Most Likely Value = $ 10,000 + $0 + $0 = $10,000.

As you can see, it makes a difference in which approach you take in coming up with your estimate. We can use an expected value of $ 15,000, an average value of $ 20,000, or a most likely value of $ 10,000. Therefore, it is very to go through a decision based approach to estimation. You accomplish this by calculating expected values.

Considerations for Budgeting Software

Budgets are often prepared with the use of spreadsheets. As an organization grows and becomes more complex, the use of spreadsheets must give way to formal budgeting applications. A database of spreadsheets with increased functionality can significantly improve the budgeting process. Here are some features to look for in formal budgeting software:

1. Database Functionality: Each budget dimension (cost center, general ledger account, business segment, etc.) should stand separately so that data can be mapped against each dimension. This allows the user to view budgets by whatever x and y dimension he or she chooses.
2. Bi-Directional Calculations: It should be easy to make random changes to budgets within any level of the organization. Changes should be made from the top and the bottom at the same time. For example, a 5% cut to all departments is made and at the same time, the Marketing Department Budget increases its line item for research.
3. Multi User Sharing: The budget system should not be restricted to any single user. By allowing users to share access to the same database, duplicative procedures are eliminated. Obviously, the budgeting system should include line item security controls for each dimension within the system.
4. Easy to Learn & Use: The budgeting system should be simple and data entry should be self-explanatory. A spreadsheet like feel can help reduce learning time since most professionals are very familiar with spreadsheet programs.
5. Customizable: The actual calculation logic should be subject to modification by the user since one size does not fit all. Users need the ability to customize how budgets are prepared to meet the needs within the organization.
6. Audit Trails: It should be easy to tell who made a revision to the budget. The amount and variance associated with the revision should be easy to identify within the budgeting system.

7. External Importing of Data: The budgeting system should be able to import data from external systems. This can streamline the process and make budgeting more of a value-added activity.

Good budgeting programs should include features like "what if" analysis and customization options at each budget control point. The real power of automating the budgeting process can be found in consolidating large volumes of data and integrating all budget control points into a single, unified budgeting system.

One alternative to budgeting software is the use of Application Service Providers (ASP's) for the overall budgeting process. This so-called e-planning alternative offers some big advantages over formal installation of enterprise software:

- Rapid deployment throughout the entire organization.
- Bypasses the costly life cycle of designing and implementing formal programs.
- Ensures consistent integration throughout the entire organization
- Instantly transforms budgeting into a dynamic, real time process where on-line templates are used to update budget information.

Whichever option you choose, budgeting software or ASP's, you will need to have a process that is flexible and responsive to constant change. The single biggest problem in budgeting often boils down to failure to integrate the process. This should be a key concern in whichever option you choose.

Project Evaluations

Basic Economics for Capital Budgeting Analysis

Planning for capital assets involves a process of calculating the Net Present Value of the investment. Net Present Value is calculated by discounting the future changes in cash inflows and cash outflows using the weighted average cost of capital. The resulting present value of cash flows is compared to the Net Investment for the Capital Asset. The result is called Net Present Value. It should be noted that Net Investment includes all costs to place the capital asset into service plus any working capital requirements. If the capital asset has above average risks, than we would increase the weighted average cost of capital.

If the Net Present Value is positive, this indicates that value is added by making the investment. If the Net Present Value is negative, this indicates value destroyed. The objective is to have a total asset portfolio where the total Net Present Values are above zero. Besides Net Present Value, we can use Internal Rate of Return and Discounted Payback Period to evaluate capital projects.

Internal Rate of Return is the rate of return that the project earns. It is calculated by finding the discount rate whereby the total present value of cash inflows equals the total present value of cash outflows. Modified Internal Rate of Return can be used to remove the assumption that funds are reinvested each year at the Internal Rate of Return. We can also calculate the number of years it takes to recoup our Net Investment. Simply calculate a running total of the discounted cash inflows to determine the Discounted Payback Period.

Net Present Value, Internal Rate of Return, and Discounted Payback Period are three popular economic criteria for evaluating whether or not to invest in a capital asset. All three concepts give consideration to the time value of money. Estimating incremental cash flows is one of the most difficult steps in the overall evaluation process.

What is Internal Rate of Return?

The actual rate of return earned on a project is called Internal Rate of Return (IRR). The Internal Rate of Return is the discount rate where the total present value of cash outflows equals the total present value of cash inflows. For projects with equal cash flows, a payback calculation can be used to find the IRR. If projects have varying cash flows over the life of the project, a trial and error approach must be used. However, most spreadsheet programs include an IRR formula which makes the calculation very simple.

Example: We have a project with an initial cash outlay of $ 40,000 and cash inflows each year are $ 10,000 over the next five years.
$ 40,000 / $ 10,000 = 4.0 factor, look up the 4.0 factor under Present Value of Annuity Table, across for periods = 5, we find 3.993 under 8%. The Internal Rate of Return is approximately 8%.
Using Microsoft Excel Spreadsheet: Enter all cash outflows and inflows into cells A1 to A7: - 40000, +10000, +10000, +10000, +10000, +10000. Make sure you enter your amounts in the correct order. From the menu bar, click Insert / Function / Financial / IRR into a separate cell. The formula should appear as =IRR(A1:A7).

It should be noted that IRR is probably the most popular economic criteria for evaluating capital projects. IRR is best used in conjunction with other economic criteria, such as Net Present Value and Discounted Payback.

Using Discounted Payback

Perhaps one of the most popular economic criteria for evaluating capital projects is the payback period. Payback period is the time required for cumulative cash inflows to recover the cash outflows of the project. For example, a $ 30,000 cash outlay for a project with annual cash inflows of $ 6,000 would have a payback of 5 years ($ 30,000 / $ 6,000).

The problem with the Payback Period is that it ignores the time value of money. In order to correct this, we can use discounted cash flows in calculating the payback period. Referring back to our example, if we discount the cash inflows at 15% required rate of return we have:

Year 1 - $ 6,000 x .870 = $ 5,220	Year 6 - $ 6,000 x .432 = $ 2,592
Year 2 - $ 6,000 x .765 = $ 4,536	Year 7 - $ 6,000 x .376 = $ 2,256
Year 3 - $ 6,000 x .658 = $ 3,948	Year 8 - $ 6,000 x .327 = $ 1,962
Year 4 - $ 6,000 x .572 = $ 3,432	Year 9 - $ 6,000 x .284 = $ 1,704
Year 5 - $ 6,000 x .497 = $ 2,982	Year 10 - $ 6,000 x .247 = $ 1,482

The cumulative total of discounted cash flows after ten years is $ 30,114. Therefore, our discounted payback is approximately 10 years as opposed to 5 years under simple payback. As the required rate of return increases, the distortion between simple payback and discounted payback grows. Discounted Payback is more appropriate way of measuring the payback period since it considers the time value of money.

Using Decision Trees

Too often Financial Managers rush into a capital project by simply analyzing the cash flows. Since high levels of uncertainty are associated with most capital projects, the first place to start is with an analysis of the decision itself. Decision Trees are extremely useful for mapping-out a decision so that all alternatives are considered in relation to probabilities. Decision trees walk you through the different stages and events within the project. Expected values are calculated and a logical outcome is presented for making the right selection.

Several computer programs are available to automate the decision making process. Two popular programs are InfoHarvest (www.infoharvest.com) and Expert Choice (www.expertchoice.com). These programs allow you to build a tree through each period of your capital project. This process can be particularly useful when certain events are conditional on other events. Finally, decision tree programs can be used for all types of applications, such as make or buy decisions, marketing decisions, technology decisions, etc. If you are interested in a structured approach to decisions with high levels of uncertainty, decision trees can be invaluable.

Capital Management

What is Your Cost of Capital?

There is a cost of doing business that must serve as your benchmark for how you invest in long-term assets. This costs is called *Cost of Capital*. Cost of Capital is the rate you pay to those who lend or invest money into your business. You can think of Cost of Capital as the rate of return investors require for incurring risk whenever they give you money. Cost of Capital applies to long-term funding of assets as opposed to short-term funding of working capital.

Why is Cost of Capital so important? Well, you have to earn an overall rate of return on your assets that is higher than your cost of capital. If not, you end-up destroying value. So how do you calculate Cost of Capital? The most popular approach is called the Capital Asset Pricing Model or CAPM. CAPM estimates your cost of equity by taking a risk free rate and adjusting it by risks that are unique to your company or industry. Long-term government bonds are often used to estimate risk free rates while overall market premiums run around 6%.

CAPM is not perfect since it has many unrealistic assumptions and variations in estimates. For example, sources (Bloomberg, S & P, etc.) for reporting market risks of specific companies provide very different estimates. Additionally you might find simple estimates are just as accurate as CAPM. For example, simply adding 3% to your cost of debt may provide a reasonably accurate estimate of your cost of capital. You can also look at companies that are very similar to your company. In any event, you need to calculate your cost of capital since it is an extremely important component in financial management decision-making.

Calculating Weighted Average Cost of Capital

Weighted Average Cost of Capital (WACC) is the overall costs of capital. WACC is based on your current capital structure. Market values are used to assign weights to different components of capital. It should be noted that market weights are preferred over book value weights since market values more closely reflect how you raise your capital. Market weights are calculated by simply dividing the market value for each component by the sum of market values for all components. The following example illustrates how you calculate weighted average cost of capital.

Current Capital Structure consists three components: Long-term Debt (10 year A Bonds) with a book value of $ 400,000 and a cost of capital of 6.0%. Common Stock with a book value of $ 200,000 and a cost of capital of 18.0%. Retained Earnings with a book value of $ 50,000 and a cost of capital of 16.0%.

1. Determine Market Values for Capital Components. 10-Year grade A bonds are selling for $ 1,150 per bond and the common stock is selling for $ 40.00 per share. Assume we have 500 bonds outstanding and 15,000 shares of stock outstanding. Market Value for Debt is $ 575,000 ($ 1,150 x 500) and Market Value for Stock is $ 600,000 ($ 40.00 x 15,000).

2. Allocate the Equity Market Value between Common Stock and Retained Earnings based on book values. Common Stock = $ 480,000 ($ 200,000 / $ 250,000 x $ 600,000). Retained Earnings = $ 120,000 ($ 50,000 / $ 250,000 x $ 600,000).

3. Calculate the WACC using market weights:

The Debt (Bonds) has a market weight of .49 ($ 575,000 / $ 1,175,000) x .06 cost of capital = .029. Stock has a market weight of .41 ($ 480,000 / $ 1,175,000) x .18 cost of capital = .074. Finally, Retained Earnings has a market weight of .10 ($ 120,000 / $ 1,175,000) x .16 cost of capital = .016. This gives us a Weighted Average Cost of Capital of .119 or 11.9% (.029 + .074 + .016).

Capital Structure Theory

The theory behind capital structure is to find the right mix of long-term funds that minimizes the costs of capital and maximizes the value of the organization. This ideal mix is called the optimal capital structure. It can be argued that an optimal capital structure really doesn't exist since changing the mix of capital will not change values.

However, four approaches can be used to find the optimal capital structure. They are Net Operating Income (NOI), Net Income (NI), Traditional, and Modigliani-Miller. It should be noted that all of these approaches assumes no income taxes exists, all residual earnings are distributed as dividends, and operating risks remain consistent.

The NOI approach holds that costs of capital is relatively the same regardless of the degree of leverage. The NI approach takes the opposite view; costs of capital and market values of companies are affected by the use of leverage. The Traditional Approach is a mix of both the NOI approach and the NI approach. Finally, the Modigliani-Miller view is that costs of capital and market values are independent of your capital structure. In practice, there are many factors that influence capital structure. They include growth in sales, asset composition, risk attitudes within the organization, etc. The best approach seems to be to focus on a range of capital structures in managing the organization.

Capital Structure Analysis Using EBIT-EPS

One way of determining the right mix of capital is to measure the impacts of different financing plans on Earnings Per Share (EPS). The objective is to find the level of EBIT (Earnings Before Interest Taxes) where EPS does not change; i.e. the EBIT Breakeven. At the EBIT Breakeven, EPS will be the same under each financing plan we have under consideration. As a general rule, using financial leverage will generate more EPS where EBIT is greater than the EBIT Breakeven. Using less leverage will generate more EPS where EBIT is less than EBIT Breakeven.

EBIT Breakeven is calculated by finding the point where alternative financing plans are equal according to the following formula:

(EBIT - I) x (1.0 - TR) / Equity number of shares after implementing financing plan.
I: Interest Expense TR: Tax Rate Formula assumes no preferred stock.

The formula is calculated for each financing plan. For example, you may be considering issuing more stock under Plan A and incurring more debt under Plan B. Each of these plans will have different impacts on EPS. You want to find the right plan that helps maximize EPS, but still manage risks within an acceptable range. EBIT-EPS Analysis can help find the right capital mix for high returns and low costs of capital.

What is Intellectual Capital?

For publicly traded companies, capital is raised by issuing debt or equity which in turn is invested into assets. Hopefully these capital investments will earn a rate of return higher than your cost of capital. Capital assets are reported on the Balance Sheet. As the World becomes more and more competitive, the returns generated by assets **not** reported on the Balance Sheet becomes much more important. And for some organizations, this may represent the single biggest source of value-creation!

One of these *hidden* assets for creating value is so-called **Intellectual Capital**. Intellectual Capital (IC) is the intangible stuff that provides your organization with knowledge, strategy, customer service, etc. Internal sources of IC include your people who possess the knowledge and expertise to make your organization work. Internal IC also includes your management information systems, brand names, and copyrights. External IC would represent your loyal customers and suppliers.

IC received widespread attention when Thomas Stewart published his book: Intellectual Capital: The New Wealth of Organizations. As a result, many companies now recognize that value-creation goes outside traditional capital. This intense interest in IC has prompted some companies to create Managers of Intellectual Capital.

Finally, how do you measure IC? Well it's not easy since IC is such a new concept. Measurement of IC can include things like employee qualifications, customer retention rates, and registered copyrights. For now, most companies are focused on measuring the traditional sources of capital. However, in the future Intellectual Capital may become one of the most important components of value-creation.

Recognizing Intellectual Capital

Financial professionals are increasingly apprehensive over the traditional accounting model. Financial statements, the main product of the traditional accounting model, are extremely inadequate for reporting the valuations behind a business. Real values, not book values, are the focus of attention within financial management. According to New York University, a typical set of financial statements will only disclose about 15% of the market value of a business. In order to bridge the gap between market values and book values, we need to recognize something called intellectual capital.

By using a set of intellectual capital accounts, an organization better understands and communicates the sources of value. Unlike financial accounts, intellectual capital accounts have a long-term perspective. They stress the importance of spending time and resources on the intangibles within the business. Therefore, intellectual capital accounts support growth, development, and innovation. These are the real sources of value within a business.

In a world where knowledge is critical, intellectual capital accounts will capture and report knowledge as one of the principal assets within the business. We no longer look at our business within the confines of the Balance Sheet, focusing only on fixed tangible assets. The intangible assets (such as knowledge, people, customers, systems, etc.) represent the stimulus for growth and value creation. The use of intellectual capital accounts can provide several benefits, including:

- Stresses the importance of developing knowledge, people, technology, and other components of intellectual capital.
- Supports organizational development in those areas that have the biggest impact.
- Provides a better indication of long-term growth.
- Assists in strategic decision making since we now have a better understanding of where our growth comes from.
- Supports how financial capital is deployed and managed, improving returns and financial performance.

Setting up a set of intellectual capital accounts can be very creative. Most organizations seem to focus on at least four resource categories:

1. Human Resources - Knowledge, education, qualifications, abilities, strategic thinkers, etc.
2. Customers - Loyalty, retention, brands, agreements, etc.
3. Technology - Networks, data warehousing, executive information systems, etc.
4. Processes - Value added activities, efficiencies, cost, etc.

Intellectual capital accounts will need to capture the values associated with intangible resources within the four categories defined above. In order to accomplish this, we will need to establish a structure or definition for each intellectual capital account. Intellectual capital accounts are often defined within three measurement layers:

1. Define what needs to be measured, such as level of professional development of personnel.
2. Define the metric to be used, such as number of continuing professional development hours completed.
3. Define the desired outcome, such as 80 hours average within the organization.

In conclusion, resource categories are the foundation for building the content of intellectual capital accounts. The objective is to capture through measurement your position, compare the results through reporting, and take action to improve how intellectual capital is being managed. This in turn leads to better implementation of the corporate strategy and vision. And this will lead to higher market valuations.

Ratio Analysis

Cash Flow Ratios

Although not widely used, cash flow ratios can be useful in determining the adequacy of cash and cash equivalents. Cash flow ratios are used depending upon the critical needs of cash. For example, if cash is critical to servicing long-term debt, than Cash Flow to Long-Term Debt would be a good ratio. If liquid assets are critical to meeting current liabilities, than Cash + Marketable Securities to Current Liabilities would be useful. Some of the variations for cash flow ratios include:

Cash Flow / Total Debt, Cash Flow / Long-Term Debt, Cash + Marketable Securities / Working Capital, Cash + Marketable Securities / Current Liabilities.

Another good cash flow ratio is Operating Cash Flow to Net Income. This ratio shows the extent to which Net Income is supported by operating cash flows. Cash flow from operations is calculated by adjusting Net Income for non-cash items, such as depreciation. Cash flow is reported on the Statement of Cash Flows and cash flow ratios can be calculated from a complete set of financial statements.

Accounts Receivable Ratio Analysis

Ratio analysis can be used to tell how well you are managing your accounts receivable. The two most common ratios for accounts receivable are turnover and number of days in receivables. These ratios are calculated as follows:
Accounts Receivable Turnover = Credit Sales / Average Receivable Balance.

Example: Annual credit sales were $ 400,000, beginning balance for accounts receivable was $ 55,000 and the yearend balance was $ 45,000. The turnover rate is 8, calculated as follows: Average receivable balance is $ 50,000 ($ 55,000 + $ 45,000) / 2. The turnover ratio is $ 400,000 / $ 50,000. This indicates that receivables were converted over into cash 8 times during the year.

Number of Days in Receivables = 365 Days in the Year / Turnover Ratio. Using the same information from the previous example gives us 46 days on average to collect our accounts receivable for the year.

Two other ratios that can be used are Receivables to Sales and Receivables to Assets. Referring back to our first example, we would have a Receivable to Sales Ratio of 12.5% ($ 50,000 / $ 400,000). Remember ratios are only effective when used in comparison to other benchmarks, trends or industry standards. A turnover ratio well below the industry average would indicate much slower conversion of receivables than other companies. A much lower Receivables to Sales Ratio than the industry average might indicate much better policies in getting sales converted into cash.

Asset Ratio Analysis

The ability to generate revenues and earn profits on assets can be measured through ratio analysis. Several types of ratios can be calculated regarding the utilization of assets.

Example: Asset Turnover gives an indication of how often assets are converted into sales. The Asset Turnover Ratio is calculated as follows: Sales / Average Assets. If annual sales were $ 200,000 and the average asset balance for the year was $ 160,000, the asset turnover rate would be 1.25. A higher turnover rate implies effective use of assets to generate sales.

Receivable and Inventory ratios are part of asset ratio analysis. Inventory Turnover gives an indication of how much inventory is held during the reporting period. Example: Cost of Goods Sold for the Year was $ 270,000 and the average inventory balance during the year was $ 90,000. This results in an inventory turnover rate of 3 ($ 270,000 / $ 90,000). The average number of days inventory is held is calculated as follows: 365 days in the reporting period / inventory turnover rate. In our example, this would be 122 days.

Finally, you can look at the use of capital for generating revenues. Two common ratios are Total Capital Turnover and Investment Rate. Total Capital Turnover is calculated as: Sales / Average Total Capital. Average Total Capital consists of both debt and equity. The Investment Rate is the rate of change in capital. The Investment Rate is calculated by simply dividing the amount of change in capital / total beginning capital. A high investment rate would imply an aggressive program for generating future sales.

Accounts Payable Ratio Analysis

Ratio analysis can be used to determine the time required to pay accounts payable invoices. This ratio is calculated as follows: Accounts Payables / Purchases per Day. For example, assume we have total accounts payables of $ 20,000 and our annual purchases on account total $ 400,000. Our purchases per day are $ 400,000 / 365 days in the annual reporting period or $ 1,096. The average number of days to pay accounts payable is $ 20,000 / $ 1096 or 18 days. The result of this ratio should be compared to the average terms available from creditors.

If the average number of days is close to the average credit terms, this may indicate aggressive working capital management; i.e. using spontaneous sources of financing. However, if the number of days is well beyond the average credit terms, this could indicate difficulty in making payments to creditors.

Another ratio that can be used in managing accounts payable is Sales to Accounts Payable. This ratio gives an indication of a company's ability to obtain interest free funds. For example, if we had sales of $ 600,000 and accounts payables of $ 20,000, this gives us a ratio of 30. As this ratio increases, it becomes more difficult to obtain trade credit.

Managing Return on Equity

For publicly traded companies, one of the most watched financial measurements is return on equity. Return on Equity is calculated by dividing Net Income over Average Shareholder's Equity. Financial Managers break this ratio down into three components for managing the organization. The three components of Return on Equity are: Return on Sales, Asset Turnover, and Financial Leverage. Therefore, we can breakdown Return on Equity as: (Net Income / Sales) x (Sales / Assets) x (Assets / Equity).

Example: Net Income is $ 100,000, Equity is $ 400,000, Sales were $ 500,000 and Assets are $ 600,000. Return on Equity = ($ 100,000 / $ 500,000) x ($ 500,000 / $ 600,000) x
($ 600,000 / $ 400,000) = .20 x .8333 x 1.50 = .25 or 25%.

The trick is to manage these three components in such a way that you maximize Return on Equity. Remember if you increase one ratio, it will decrease a corresponding component. For example, if you were to increase assets, this would increase your leverage (assets / equity), but would decrease your turnover (sales / assets). Additionally, you can further breakdown the three component ratios into more detail ratios. For example, the first component ratio is Return on Sales. This can be broken down into Operating Margin on Sales. The point is to start at the top - Return on Equity and move to the middle layer (3 component ratios) and than move to the bottom layer (detail ratios).

Profitability Ratios

Profitability Ratios are used to evaluate management's ability to create earnings from revenue-generating bases within the organization. Profitability Ratios measure the earnings by dividing the earnings by a base, such as assets, sales or equity. Four common profitability ratios are:

Profit Margin on Sales = Net Income / Sales
Operating Margin on Sales = Earnings Before Interest & Taxes / Sales
Return on Assets = Net Income / Average Assets
Return on Equity = Net Income / Average Common Equity

Example: Net Sales (Gross Sales less Allowances) are $ 500,000.

Earnings Before Interest and Taxes are $ 50,000 and Net Income is $ 25,000. Asset Balances are: Beginning $ 190,000 and Ending $ 210,000
Common Stock Balances: Beginning $ 325,000 and Ending $ 325,000
Retained Earnings Balances: Beginning $ 100,000 and Ending $ 150,000.

Profit Margin = $ 25,000 / $ 500,000 = .05 or 5%
Operating Margin = $ 50,000 / $ 500,000 = .10 or 10%
Return on Assets = $ 25,000 / ($ 190,000 + $ 210,000) / 2 = .125 or 12.5%
Return on Equity = $ 25,000 / ($ 425,000 + $ 475,000) / 2 = .055 or 5.5%

Profitability ratios are widely used by creditors, investors, and others who are interested in finding out how management generates its earnings.

Operating Cost Ratios

Ratios can be used to help measure the effectiveness over cost control. Operating costs can be monitored with the use of direct and indirect operating ratios. Examples of Direct Operating Ratios are:
Direct Labor to Sales = Direct Labor Costs / Sales
Direct Materials to Sales = Direct Materials / Sales
Factory Overhead to Sales = Factory Overhead / Sales

Indirect Operating Ratios can be computed for almost any itemized expense. Two examples are:
Computer Expenses to Sales = Computer Expenses / Sales
Travel Expenses to Sales = Travel Expenses / Sales

Example: Direct Labor Costs are $ 100,000 Factory Overhead is $ 200,000, Computer Expenses are $ 15,000 and Sales were $ 500,000.
Direct Labor to Sales = $ 100,000 / $ 500,000 = .20 or 20%
Factory Overhead to Sales = $ 200,000 / $ 500,000 = .40 or 40%
Computer Expenses to Sales = $ 15,000 / $ 500,000 = .03 or 3%

Operating cost ratios are often used by production managers to monitor trends and identify problems. If a significant change occurs, the problem must be identified as either internal (such as operations) or external (such as economic conditions). Since investors and other outsiders don't have access to operating information, operating ratios are rarely used outside the organization.

Measuring Sustainable Growth

Is there such a thing as too much growth? In financial management, we try to balance the management of growth with our asset base. For example, if sales were to grow too fast, than we would deplete our financial assets resulting in extreme risks to the organization. If sales grow too slow, than we run the risk of destroying value by holding assets that earn a rate below the cost of capital. The objective in financial management is to manage a sustainable rate of growth that creates value year after year.

The growth rate in sales is limited by the growth we can obtain from the equity side of the Balance Sheet. Therefore, sustainability is a function of equity growth rates, not sales growth rates. The formula for calculating a sustainable growth rate (G) is:

G = Margin x Turnover x Leverage x Retention
Margin = Net Income / Sales
Turnover = Sales / Assets
Leverage = Assets / Equity
Retention = % of Earnings Retained

Consequently, if we want to maintain a consistent level in profit margins, asset turnover, leverage, and retained earnings, than we should grow our sales by G (sustainable growth rate). Changing the sustainable growth rate is a function of the four components of sustainable growth. For example, eliminating marginal products can increase the Margin component or paying out less dividends will increase the Retention component. The trick is to manage the four components so that sales growth follows the sustainable growth rate.

Using the Z Score to Assess Bankruptcies

Financial insolvency or bankruptcy can be forecasted using the Z Score. The Z Score combines several ratios with a statistical application called MDA - Multiple Discriminate Analysis. The Z Score is highly accurate in predicting bankruptcies. The Z Score is about 90% accurate in forecasting business failures the first year and about 80% accurate the second year.

The Z Score is calculated by adding five ratios with applicable MDA weights:

Z = 1.2 (A) + 1.4 (B) + 3.3 (C) + .6 (D) + .999 (E)

A: working capital / total assets
B: retained earnings / total assets
C: earnings before interest taxes / total assets
D: market value of equities / book value of debt
E: sales / total assets

The following guideline is used to score an organization:
If the Z Score is 1.8 or less, very high probability of bankruptcy.
If the Z Score is 1.81 to 2.99, not sure about bankruptcy.
If the Z Score is 3.0 or higher, bankruptcy is unlikely.

Example: Total Assets = \$ 1,000, Retained Earnings = \$ 400, Earnings Before Interest Taxes = \$ 50, Sales = \$ 1,500, Market Value of Stock = \$ 600, Book Value of Debt = \$ 700, Working Capital = \$ 100.

1.2 x (\$ 100 / \$ 1,000) = .120
1.4 x (\$ 400 / \$ 1,000) = .560
3.3 x (\$ 50 / \$ 1,000) = .165
.6 x (\$ 600 / \$ 700) = .514
.999 x (\$ 1,500 / \$ 1,000) = 1.499
Total Z Score = 2.86 Not Sure

Valuations of Mergers & Acquisitions

The basic principle for valuing a business combination is similar to capital budgeting of projects. If the present value of incremental cash flows from the merger exceeds the present value of the amounts paid, than the investment should add value. This concept is referred to as Net Present Value. In order to calculate Net Present Value (NPV), you must:

- Determine the expected cash flows of the target company.
- Determine the effect the merger will have on the combined cost of capital of the new entity.
- Determine the amount that will be paid for the target company. A higher price should only be paid if there is definite synergy values.

Estimates of cash flows can be seriously distorted if management has plans to change the future operations of the combined entity. Make sure you have a good understanding of future strategic plans. Your estimate of cash flows should include any additional cash outflows that will be incurred from the issuance of new debt. Cash flow estimates need to be based on sensitivity analysis of how NPV changes when a critical variable is changed. Using a decision tree model will help determine the expected value from a range of possible values.

The discount rate you should use in discounting the cash flows should be the Cost of Equity of the combined company or the target company; depending upon which cash flow stream you are measuring. Remember you are buying the equity or ownership of the target company. You may need to adjust the discount rate for additional risks incurred from the use of funds. If you are using the Capital Asset Pricing Model, you will need to determine a new Beta coefficient. Finally, don't forget to include an estimate for terminal values beyond your forecasted cash flows.

Obviously this overview touches on the very basics in acquiring the equity of another company. A good book on valuing companies is Valuation: Measuring and Managing the Value of Companies by three consultants with McKinsey & Co.

The Underlying Sources of Value-Creation: Innovation and Speed

If someone were to ask me what is the greatest strategic advantage any organization can have in the global marketplace? My response would be INNOVATION. Innovation is one of the greatest generators of value. Innovation can lead to new markets, new customers, new products; all of which generates a lot of value. Unfortunately, innovation is very difficult to achieve. One of the best places to find innovation is in France. The French are great at innovation, everything from eye surgery to flat free tires. Because of this incredible level of innovation, the French economy has the largest trade surplus of any nation.

So how do the French generate so much innovation? Well think about how the French approach business. They are very visual in how they solve problems; i.e. use gauges and pictures to explain and solve problems (Balanced Scorecard). The French allocate lots of time to creative thought, not to creative work. In fact the French tend to minimize work; they almost have a disdain for work. Because of this freedom, the French can react quickly to market conditions without having "work" get in the way. And remember what Tom Peters and others keep preaching: *It's the fast over the slow that will survive in the future, not the big over the small*.

The ability to react quickly to events, customers, markets, new technologies, and other issues can make or break companies in the future. For example, years ago Bill Gates, founder of Microsoft, dismissed the Internet as inconsequential. Year's later Mr. Gates changed his views on the future of internet. What's so amazing is that Microsoft (a very large company) was able to change directions so quickly. The ability to move fast is paramount to survival in the future.

Finally, you have got to create an environment that is conducive to creativity. This requires that you break down barriers and free people up so they can be creative. For example, one company discarded most of its personnel policy and replaced it with a single sentence on one page: "Use Your Best Judgement." Other companies are evolving into virtual organizations by having the customer run the company, not the CEO. Also recognize the importance of failure. Failure is normal and it usually comes before success. Remember innovation comes from some unusual places. You have to break away from old ideas, old values, and the status quo. Don't be afraid to challenge what is going on.

Lease Valuations

A lease is an agreement whereby the lessor (owner of property) allows the lessee use of the property in exchange for lease payments. Operating leases give the lessee the use of property without ownership. Operating leases are sometimes used to initiate off-balance-sheet financing of assets. Capital or Financing leases transfer ownership from lessor to lessee. Under capital leases, the lessee will record the asset at the present value of lease payments not to exceed the fair market value of the asset. The following examples will illustrate certain basic calculations in valuing leases. You will need to refer to present value tables to understand the source of present value factors.

Example 1: What is the value of the leased asset?
Annual lease rental payments are $ 10,000 under a 5 year lease. The financing rate for this lease is 12% and payments are made at the beginning of the year. Since payments are made at the beginning of the year, we will use a present value factor for an annuity due. Remember that many present value tables are based on year-end payments.
Step 1: Determine the present value factor to use, 4 years (n-1) and 12% gives us 3.0373 + 1.0000 = 4.0373 present value for annuity due at 12% for 5 years.
Step 2: Calculate the present value of cash flows associated with the lease.
$ 10,000 x 4.0373 = $ 40,373 Value of Leased Asset.

Example 2: What is the annual payment for a lease?
We will lease an asset that has a value of $ 50,000 over 10 years. Payments will be made at year-end with an interest rate of 14%.
Step 1: Determine the present value factor to use, 10 years and 14% gives us 5.2161
Step 2: Calculate the annual lease payments, $ 50,000 / 5.2161 = $ 9,586

Lease calculations are important when making a decision to buy or lease assets. Leases can help preserve cash flows, but leases carry higher costs over the long-run than outright purchasing of assets.

Focus on Free Cash Flow, not EBITDA!

When analyzing and determining values, there is a tendency to use shortcuts or recommended calculations. For example, Cash Flow Return on Investment is advocated by some while others like to measure value by calculating EBITDA - Earnings Before Interest Taxes Depreciation Amortization. The problem with these approaches is that they tend to bypass "free" cash flows. And free cash flows are the source of valuations.

Think of free cash flow as the amount of cash you can draw out of your organization after you've paid everything off. This is the amount you want to use for determining value. If you were to use EBITDA, you would falsely assume that the asset base will be systematically capitalized over time with no future additional reinvestments into assets. How long can your organization generate future revenues with a declining asset base? Consequently, you need to be careful about fashionable ways in arriving at valuations. Get back to Cash Flows. If you want to rely on the Income Statement, than add back non-cash items such as depreciation and subtract out future working capital requirements and future capital investments. Don't shortcut your analysis; go back to how you arrive at cash flows.

Valuation of Customers – Part 1

Most businesses recognize the importance of customers. However, few businesses will recognize customers like any other asset, assigning value to customers and categorizing this asset as the main asset for running the business. When you treat customers like an asset, you begin to manage differently. For example, some customers add value to the business while others remove value from the business. For those that add value, more resources are allocated to these types of customers. The net losers are transferred to the competition. Retaining the highest value-creating customers is the primary objective behind assigning values to customers.

The value assigned to customers is based on the future net profits generated by a customer, discounted back at the cost of service rate to a net present value. In some cases, it is necessary to account for additional values contributed by customers. For example, suppose you have a customer that refers new customers to your business or suppose you have a customer that is providing you with valuable feedback for improving your services. These types of customer attributes generate higher values.

When calculating net present values for customers, you will need to estimate the full costs of servicing the customer. This requires a cost allocation system, such as Activity Based Costing with an object layer that captures net profits by customer. Since most cost models will be hard pressed to capture all customer-related costs, you will probably have to apply some probabilities to certain cost categories. Keep in mind that we are trying to calculate a comparison of values between customers so that we can distinguish between customers adding value and customers destroying value. Ranking customers according to value requires an understanding of how customers impact the bottom line. Once we have a ranking by value, we can allocate more marketing and customer service resources to the highest value generators.

Retaining "value-adding" customers is a major challenge for every business. The range of customer values will guide you on how to allocate your limited resources. Some businesses may have a very narrow range of values; i.e. every customer adds more or less the same relative amount of value. For example, a bookstore makes more or less the same amount on each and every customer. Other businesses may find a major divergence between customer groups. For example, airlines tend to make much more money from business travelers that fly first class as opposed to vacation travelers flying coach.

The valuation process is now an integral component of managing customers. And customers are the critical assets behind every business. When we recognize that customers are different, we start to move towards customization. The process of customization is the next phase in properly managing the customer. Part 2 of this article will explore how we leverage customization as a major strategy for retaining and building customer loyalty.

Valuation of Customers – Part 2

In Part 1 of this article, we learned that valuation of assets should be applied to customers. Once we assign values to customers, we can better allocate our limited resources towards retaining the highest value-creating customers. We will now expand on what we can do to retain and build the customer asset base.

One beginning question to ask is: What customers do we want to keep? The range of values we have calculated for customers will help us answer this question. Some businesses (like a foodstore) will have narrow valuations since almost all sales are marginal. Other businesses with wide variations in profit margins will have a much more diverse spread of valuations. Wide variations in valuations will give us a customer base with a high skew curve. Businesses with wide variations and high skew curves will tend to emphasize frequent marketing programs, special sales, and other strategies directed at the high-end of the skew curve. Businesses with low skew curves have a flat customer base and thus, they will allocate their marketing efforts more uniformly throughout the entire customer mix. For businesses with low skew curves, one way to segment out customers is by their needs. For example, a clothing retailer provides numerous needs - children's shoes, men's neck ties, etc. The greater the differentiation in needs amongst your customers, the greater the need to learn from the customer.

Therefore, retaining customers is a function of gaining new knowledge about the customer. This requires that you establish a relationship with the customer. Once you begin to interact with the customer, you start to identify unique needs of the customer. This is important since customers are not interested in making choices. Customers are best satisfied when you deliver products and/or services that are customized to their specific needs. Customer retention comes from treating each and every customer differently. The most loyal customers are those who expect you to remember what their specific needs are. The more specific a customer is with your business, the more you will be able to learn from the customer. And the less likely the customer will defect and move over to the competition.

As the organization learns from the customer, it will be necessary to deliver customized products and services. The organization will have to become increasingly flexible with marketing and production. Additionally, a needs specific program should be directed at high value customers. The high value customers are the ones that you must retain. In the book Enterprise One to One, the authors Don Peppers and Martha Rogers note that a learning relationship between the business and the customer can only take place if:

- The business has the capabilities to deliver customized products and services in a cost-effective manner.
- The business has intelligence about the customer and this intelligence allows the business to anticipate customer needs.
- The business is very flexible and there is a strong interface between production, marketing, and other components of customer service.
- The customer is required to tell the business what specifications are required. Customers direct production, marketing, and other parts of customer service.

Finally, the emphasis is not on trying to bring in new customers. The emphasis is on providing more and more unique products and services. This wider product mix brings in the new customers. Consequently, the organization must be customized to meet the needs of the customer. This may require changing the organizational structure.

We no longer live in a world where one common product or service can be spread amongst the customer mix. We are quickly moving into a world where products and services are customized to meet individual customer needs. Customization based on learning from the customer is critical to value creation in the future.

Lessons from the Entrepreneur
Lesson 1: Some Basic Concepts

One of the best ways to create higher values is to simply think like an entrepreneur. If we can think like an entrepreneur, we can find numerous ways of changing how we manage and create wealth within an organization. Over the next few months, I will summarize several concepts that I believe are paramount to creating higher values. All of these concepts come from thinking like an entrepreneur. Lesson 1 (which follows) will introduce some basic concepts. Lesson 2 will explore characteristics of the entrepreneur and Lesson 3 will outline the entrepreneurial culture.

One simple lesson we can all learn from the entrepreneur is how to manage risk. Entrepreneur's think in terms of stages or increments. They never commit large resources up-front, working within a single stage. The traditional manager, on the other hand, is given a budget to complete a project and he or she will force an outcome no matter what new facts may emerge during the life cycle of a project. Compare this approach to the entrepreneur who never takes such huge risks. Entrepreneurs manage risk by making decisions incrementally and they move forward very cautiously, moving to the next stage only if a specific event or action has occurred. This approach allows the entrepreneur to better control risk as opposed to the traditional manager who takes on major risk. By not wasting valuable resources, entrepreneurs not only manage risk better, but they preserve and protect value. They also have better control over the final outcome of projects.

Another key lesson from the entrepreneur is a never-ending search for new opportunities. Entrepreneurs enjoy experimenting with new ideas, seeking out new areas to exploit. Contrast this to the traditional manager who avoids experimentation, focusing on his or her career within the organization and not thinking outside the traditional box. Entrepreneurs live for new opportunities whereas traditional managers follow a sequential pattern of procedures that conforms to the corporate culture. A strong emphasis on learning is usually at the center of finding new opportunities. Entrepreneurs seem to listen and learn much better than anyone else and as a result, they can see an opportunity much easier than the rest of us. Therefore, a major commitment to learning is at the center of identifying new opportunities to exploit.

A third lesson we can learn from the entrepreneur is that execution is more important than the idea itself. Many organizations are searching for new ideas as a way of creating higher values. New ideas are hard to come by and they rarely result in the creation of value. Value comes from the ability to execute. Entrepreneurs seem to have an uncanny ability for executing an idea and turning something redundant into a great business. For example, something as simple as coffee all of a sudden becomes Starbucks, an international chain of coffee shops. It's not the product or service that creates value, it is all of the intangibles associated with the product or service that seems to attract customers and creates value. Entrepreneurs understand this concept and they know how to execute an idea much better than the traditional manager. Keep in mind that over 70% of all new ventures come from existing ideas, not new ideas. Execution is how entrepreneurs create value.

In conclusion, we have learned three important concepts from the entrepreneur:

1. Thinking in stages or increments is a value-creating approach to risk management.
2. Allowing experimentation to take place is paramount to value creation. This requires a very strong commitment to continuous learning; otherwise you will have difficulty identifying new opportunities.
3. Existing ideas are much more important than new ideas when it comes to creating value. The challenge is to transform an existing idea into something that is new to the marketplace; i.e. execution.

In our next lesson, we will learn some of the basic characteristics behind the entrepreneur.

Lessons from the Entrepreneur
Lesson 2: Characteristics of the Entrepreneur

In our first lesson, we described a few basic concepts that entrepreneurs follow in managing a business. We will now expand on how entrepreneurs create value by looking at some characteristics of entrepreneurs. One common characteristic behind almost every entrepreneur is a strong commitment to a set of skills. Invariably you will find that entrepreneurs are extremely highly skilled in their chosen profession and as a result, they can attract customers based on this high level of expertise. Entrepreneurs are able to exploit this expertise and build a business around what they are good at. Entrepreneurs do not digress or move into areas where their skills are weak. If an entrepreneur requires other skills, the entrepreneur will seek out partners or build a management team. Keep in mind that almost every entrepreneurial business will require at least three skills: marketing, product, and finance. You have to be able to sell and reach the customer. You have to be able to create a product that creates value for the customer. Finally, you must be able to raise the money to execute your business. Entrepreneurs know how to cover all three of these skills.

Another common characteristic to most entrepreneurs is a love for what it is they do. Entrepreneurs have a passion for their work which helps them persevere through hard times. This strong commitment allows entrepreneurs to compete and overcome numerous obstacles. Failure is part of the process of building the entrepreneurial business. Most entrepreneurs will experience a lot more failures than successes. However, they persevere through failures by learning from failures and they build on this new knowledge. Therefore, "intelligent" failing is an integral part of how entrepreneurs create value.

A third characteristic common to most entrepreneurs is a low resource need. Entrepreneurs are customer dependent and not resource dependent. Entrepreneurs seem to create value with minimal resources. This low support need is one of the reasons why so many entrepreneurial businesses create so much value. Contrast this to the big corporation where huge resources are plowed into projects, resulting in wasted resources and the destruction of value. Entrepreneurs create businesses with minimal capital investments. This in turn generates an extremely high return on invested capital and thus, high valuations for the business.

In summary, we can list several characteristics common to entrepreneurs:

- Extremely high skills resulting in benefits to customers.
- Strong commitment to building value with failure as a normal part of the process.
- Low support needs and thus, high valuations are possible.
- Focused on the needs of the customer. The customer is the ultimate solution within every business.
- Does not follow a pre-set path or structure; experiments through a meandering journey.
- Informal, open communication style that allows a conversation to take place and thus, entrepreneurs are always learning.
- Very sensitive to what works and what does not work. Entrepreneurs are very observant.

In our final lesson on entrepreneurship, we will look at how your organization can create an entrepreneurial culture.

Lessons from the Entrepreneur
Lesson 3: The Entrepreneurial Culture

It should go without saying that we now function in a world of intense competition. Additionally, those who invest in companies are becoming less and less confident in management's ability to create value. As a result, financial markets are becoming increasingly volatile. We also need to consider things like shorter product life cycles. Because of these factors and many more, it is absolutely imperative for every organization to build an entrepreneurial culture. This article will summarize some key components within the entrepreneurial culture.

As you may recall from Lesson 1, entrepreneurs never manage projects in a single stage. They think in terms of increments and they always learn from their mistakes. Traditional organizations destroy the project spirit by prohibiting people from going back to design or planning and thus, changes are not allowed. This in turn forces an outcome that never fits. Entrepreneurs have the freedom to experiment. People can stretch and take risk, bringing new ideas into the organization. Traditional organizations restrict experimentation through an array of memo's, meetings, policies, politics, etc. Therefore, an entrepreneurial culture allows people to experiment in a "non-judgmental" environment. No idea is judged or ridiculed.

An informal management style is also important to the entrepreneurial culture. Informal and open organizations allow anyone to communicate with anyone else anytime, anywhere. This fosters innovation and change. An entrepreneurial culture will reinforce innovation through incentive programs, rewarding people for their new ideas. Entrepreneurs also create informal environments by making everyone equal. This is symbolized by not having lush offices, large bonuses, private parking, and other special perks. Everyone exists within the same environment. Contrast this to the traditional organization where numerous perks and other attributes segment the workforce. Only when you minimize all differences can you expect people to be viewed equally. Once everyone is equal, an entrepreneurial culture of open communication and new ideas will emerge. And don't forget to share the power and the rewards. Empowerment is part of equality.

In order to have creativity and innovation, we need to have an environment that is fun. For example, Southwest Airlines has a "fun" corporate culture thanks to its President, Herb Kelleher. As Kelleher has pointed out, intangibles like a "fun" culture are extremely difficult for the competition to replicate and as a result, this becomes the competitive advantage for a company like Southwest Airlines. Creating these intangibles is a major challenge in building the entrepreneurial culture.

One way many organizations create innovative cultures is to get into the habit of introducing new products and/or services. A continuous flow of new products or services seems to ensure that the organization is operating in a creative mode.

Finally, don't forget to communicate your strategies over and over again. It is absolutely critical that everyone has a clear understanding of the strategic objectives of the organization. According to Kaplan and Norton, less than 10% of the people in a typical organization will truly understand what the organization is about and where it is going.

In conclusion, all organizations can gain enormously by simply changing their cultures over to an entrepreneurial culture. In today's world of intense competition, an entrepreneurial culture is critical to staying ahead of the competition. Learning from the entrepreneur is one of the best approaches to creating long-term value for each and every organization.

Intangibles over Tangibles

In today's information age, the emphasis is on intangibles. We no longer live in a world where physical assets are more valuable than intangible assets. High levels of business performance are more dependent upon intangible characteristics:

· Ability to innovate
· Ability to change
· Speed to Market
· Develop and Retain the Best People
· Create a One to One Customer Relationship

The marketplace also recognizes the value of intangibles. For example, companies like Microsoft have a market capitalization driven by intellectual and intangible attributes. And companies like Microsoft have market capitalization's well above companies operating with heavy loads of physical, tangible assets.

"Our primary assets, which are our software and our software development skills, do not show up on the Balance Sheet at all." – Bill Gates of Microsoft

When Financial Analyst were asked to rank the best non-financial measurements, they listed the following:

1. Execution of Strategy
2. Management Creditability
3. Quality of Corporate Strategy
4. Innovation
5. Ability to Attract and Retain Talented People
6. Market Share
7. Management Expertise
8. Alignment of Compensation with Shareholder Interest
9. Research Leadership
10. Quality of Major Business Processes

If you look at this list, most of it relates to the intangibles within the business; things like leadership, quality of management, people, ability to innovate, etc. This is what investors are looking for within a business. So how do you manage in this world of intangibles? In comparison, the World of Intangibles is considerably different than the traditional business world of physical, tangible assets.

Tangible Assets => Readily Visible, Easy to Quantify, Reported on the Balance Sheet, Easy to Duplicate, Depreciate over time, limited application, managed through control, accumulate and store.

Intangible Assets =>Difficult to Recognize, Difficult to Quantify, Not Reported on the Balance Sheet, Difficult to duplicate, Appreciates over time if managed properly, Has multiple applications to the business, Managed by alignment, and tends to be very dynamic with a short life span.

For financial professionals, this presents numerous challenges. For example, much more emphasis must be placed on growing the intangibles within the business. Within finance, this can involve things like rethinking the budget models, allocating resources differently, shifting the cost structure, and moving towards virtual financial functions.

The trend towards intangibles is real and extremely profound for business. In fact, Tom Peters in his Project 50 series of books declares that those organizations that survive will have to adopt these types of intangible attributes. Peters refers to these surviving organizations as “Professional Service Firms.”

“These firms can be tiny or huge. But regardless of size, they perform purely intellectually based services, own damn little in the way of hard assets, and sometimes deposit billions of $$$$ on the bottom line. Those who survive – on or off a corporate payroll will jettison (almost) everything they’ve learned and adopt the attributes / attitudes of a PSF / Professional Service Firm“ - Reinventing Work: The Professional Service Firm 50 by Tom Peters

The Marketplace is clearly indicating a preference for intangibles over tangibles when it comes to running a business. Therefore, businesses will have to recognize new drivers of value, such as customer led business processes, increased specialization, and an emphasis on knowledge workers. Physical assets, which are easy to duplicate in the marketplace, will no longer provide a competitive advantage. This shift from tangible to intangible is one of the reasons we are experiencing so much change. If you expect to manage change, you will have to function in the World of Intangibles.

The VDF Tool

One of the major challenges facing strategic planners is to bridge the gap between strategizing and building a performance measurement system (Balanced Scorecard). Despite attempts to bridge this gap, strategic thinking is often isolated or apart from those who develop measurement systems such as the Balanced Scorecard. In an effort to close this gap, we can focus on assets; i.e. identify those assets that we must develop for meeting strategic goals and objectives.

Similar to how the structure of a balanced scorecard allows us to reframe strategy into four or five perspectives, we can structure our strategic assets into a framework known as the Value Dynamics Framework (VDF). VDF is an organized approach to categorizing all assets that are required for strategic execution. Assets can fall into several categories, such as the following:

· Physical Assets such as inventory, facilities, equipment, vehicles, etc.
· Customer Assets such as strategic partners, suppliers, distributors, and other assets needed to service customers.
· Organizational Assets such as employees, executives, board members, organizational structures, culture, processes, reputation, etc.
· Financial Assets such as cash flow, revenues, debt, equity, and other financial resources needed for the strategy.

In his article, "Putting Strategy into the Balanced Scorecard" , Peter Brewer outlines four steps to building the VDF:

1. Identify the assets you will need to execute your strategy.
2. Map your assets into a framework, making sure everything relates to one another resulting in one cohesive model.
3. Do SWOT (Strengths, Weaknesses, Opportunities, Threats) Analysis of your VDF - make sure it works against the current competitive environment.
4. Connect critical success factors in the strategy to the assets within the VDF.

Once we have the VDF established, we can now select the appropriate measurements for the Balanced Scorecard. Measurement selection becomes easy since assets are the focal point of measurement. Therefore, the VDF Tool connects assets that drive strategy to measurements that populate the Balanced Scorecard.

Arthur Andersen, once a major accounting firm, has described the VDF Tool as a means of "cracking the value code."

" . . companies in today's superheated economies are in a race to discover the underlying code of value creation. That is, they are trying to find out which combination of assets – tangible and intangible – create the greatest economic value and to avoid those combinations that destroy it. How do companies create value today? Our answer: To succeed, they need to see what matters – all of the assets contributing to value creation."

- Cracking the Value Code by Richard E.S. Boulton, Barry D. Libert, and Steve M. Samek

By using the VDF Tool, we can help ensure that we invest in those assets that have the biggest strategic impact. Once we know where to invest, we can budget our resources accordingly. This in turn links our budgets to our strategy, something that often escapes the strategic process. Overall, the VDF Tool can be a powerful technique for exposing those assets that require major emphasis for value creation.

From Shareholder Value to Stakeholder Value

Some of the most significant sources of value for an organization are elusive, non-quantifiable and not easily discerned. One way to cast a wide-enough net for capturing these elusive elements of value is to take a stakeholder approach to the business as opposed to the traditional shareholder only view of everything. By taking this stakeholder view, resources are better utilized for long-term value creation. This approach to business can be bold in contrast to the shareholder type view, which tends to be somewhat traditional. We can begin by contrasting these two approaches:

A shareholder only approach usually has several characteristics, such as:

- Narrow Focus, driven by numbers and things that have been quantified and measured.
- Executive Management may react to valuations in dramatic ways (mergers, layoffs, etc.).
- Performance evaluation tends to be financially focused with little emphasis on intangible drivers of performance.
- Sources of value tend to be isolated systems, fragmented, and not coherent.
- Slow to respond to change; new ideas are not easily understood
- Management tends to quickly embrace a quick fix solution, sometimes adopting the latest fad despite the fact that it may not fit or it is not well-tested.
- People who create value may be viewed as "too radical" and somewhat out-of-step.
- The bottom line focus is on earnings.
- Traditional approaches to growth – allocate resources to marketing, acquire other companies, control costs, etc.
- Business success is what we create for our shareholders.

Contrary to a "shareholder" only viewpoint, stakeholder thinking tends to be deeper and broader. A stakeholder approach may include the following characteristics:

- Sustainable, competitive thinking that tends to be visionary.
- Multi-view of the organization regardless if it is quantifiable.
- Performance evaluations follow strategic issues, not just operations.
- Strong value systems across the entire value-chain, extending to external stakeholders
- Easy flow of new ideas and innovation (very change oriented).
- Management does not embrace quick fix solutions; instead opting to move cautiously and incrementally to avoid paying a heavy price.
- People who create value are most likely to advance within the organization.
- The bottom line focus is on value – what value are we adding?
- Growth through the intangibles – relationships, competitiveness, knowledge workers; thinking in terms of opportunities for growing the business around core

competencies.
- Business success is what we create for all stakeholders, not just shareholders.

"A value is a belief in action. It is a choice about what is good or bad, important or unimportant. Values shape behavior. Until a value is acted upon it remains an aspiration. Values are hard to detect; yet they underpin organizations like the foundations of a house. If the foundation is weak, then the house falls down."
- Unblocking Organizational Values by Dave Francis and Mike Woodcook

One way of moving away from shareholder value to stakeholder value is to identify the real drivers behind value creation for your stakeholders. These bottom layer drivers will give you great insight into what really works on reaching the upper shareholder layer of value. This type of thinking needs to permeate all levels of the organization so that eventually, everyone is asking the question: How does my behavior or actions impact value and what can I do to create more value?

"What people value causes organizations to have cultures and acquire the reputations they have. World-class companies usually have cutting-edge technology, superior management systems, outstanding electronic systems, and database management, but their reputations all come back to human beings – the people who make decisions and take actions in these organizations, while using technological and management systems and tools. One of the critical characteristics of successful companies is a careful balance between the values, interests, goals, and objectives of the organization, and the values of the individuals who work for it."
- Value Driven Management: How to Create and Maximize Value over Time for Organizational Success by Randolph A. Pohlman and Gareth S. Gardiner with Ellen M. Heffes

One common trap to value creation is to become overly pre-occupied with metrics. You should not confuse value creation with value-based metrics. Value type metrics are widely accepted and understood – things like EVA, Cash Value Added, Return on Investment, etc. However, the biggest sources of value (things like leadership, innovation, ethical behavior, knowledge, etc.) are not easy to quantify.

"Value is added in the sense that the situation is better than if nothing was done at all. But value is destroyed in the sense that the optimal value has not yet been implemented."
- The Value Mandate by Peter J. Clark and Stephen Neill

Value-creation is a constant and difficult struggle since we can't predict the future and many of the most important drivers of value are not measurable. Therefore, it may be appropriate to focus on only a few key drivers of value since organizational resources are limited. For example, one of the ultimate drivers of value resides in your people. So if you want to start at one single point on real value creation, begin with your human resource capital. One reason this is important is because people transcend and help you meet the value-proposition required by your other stakeholder groups –

customers, suppliers, partners, etc. People represent the fluid dynamics that binds all stakeholders, covering the full range of value-creation in this age of stakeholder value and not just shareholder value.

"We don't believe in the word 'measurement.' We don't supervise or manage people here; we lead. And we don't have employees; we have people. We don't have human resources; we have a people department. Our emotional contract with people is to treat them with respect, allow them to have input into the company, and allow them to self-actualize within their jobs."
- Stephen Smith, CEO of WestJet

Value through Strategy

Appropriate strategies are at the cornerstone of shareholder value since creating value is a function of doing things better than the competition. If you can't out-strategize the competition, then investors will show a preference towards your competitors. Therefore, creating value is very much a function of great strategic execution, done in such a way that you somehow "re-invent" the rules of the game.

"The companies that will prosper and outpace their competitors during the next two decades will be those that will be able to outthink their competitors strategically, not out muscle them operationally. The winning CEO in the future will be the one who can craft a singular strategy that gives the company a distinctive advantage." - Strategy Pure and Simple II: How Winning Companies Dominate their Competitors by Michel Robert

The link between strategy and value-creation is very profound, yet most people seem to put little energy and emphasis behind serious strategic decision-making. By shifting more of your energy on strategy, you are spending more of your time on things that matter most; i.e. things that will have the highest impact on value. So how can we get the organization to strategize more effectively? The answer is basically a three-fold proposition: Understand Yourself, Understand the Customer, and Understand the Competition.

Understand Yourself: You must understand what drives value within the organization. And strategies change and move so fast, formal approaches to strategic assessment may not work. More informal, quick approaches that focus on the real drivers or value systems seem to work best. For example, "Appreciative Inquiry" is now considered a good model for focusing on what employees, customers, and other stakeholders appreciate about the organization. This becomes the building blocks for fast, effective strategic execution.

Understand the Customer: You must understand what the customer values and what values you can provide for not just meeting the customer's requirements, but turning the customer into a loyal and long-term partner within your business.

Understand the Competition: You must understand the strategy of your competitor's. Markets are now very competitive; you cannot just narrowly focus on the customer alone. You must understand what makes the competition tick – otherwise you're in for some nasty surprises.

"Strategic Planning is seen not so much as a mathematical activity, juggling with various forecasting techniques, although some forecasts remain vital, but as an ability to understand how a business can prosper through skilful positioning in the market place. It is an exercise in vision which must be fostered; the vision must also be informed by a concentration on the need for profit." - The Visionary Executive: Strategic Planning for the New Business Leaders by Michael Z. Brooke and William R. Mills

One of the biggest inter-dependencies between value and strategy has to do with communication. Its fine to have a good strategy, but it's all for nothing if you are unable to clearly communicate it to those who must execute on it. Keep in mind that strategy is about moving and changing things in relation to the past based on what you understand in relation to customers, competition and other forces impacting your business. From all of this, you must define a compelling vision and future before others, energizing them around this strategy, allowing you to change the organization.

Creating value through strategy requires several dynamics, things like getting close to the customer and a solid understanding of competition. Perhaps the real underlying force for driving value through strategy is getting people to change. This requires that you continuously articulate a vision and strategy that people can truly execute on. Somehow you must be able to energize everyone around a common cause, communicating in such a way that it is our survival at stake – we must do these things if we expect to stay in business!

"A company that demonstrates concern for long-term success in the best interests of all stakeholders (not merely directors or shareholders) is most likely to win the respect of everyone involved in supporting it including employees, customers and suppliers. Instead of being frightened of difference and conflict, instead of pursuing power, wanting to be right, wanting to win arguments, wanting to be better than, we need to learn to welcome difference and conflict, let go, acknowledge that we don't know, that we are traveling and learning, that we will succeed better when everyone wins, that there are, most often, win-win situations. We need to learn to listen with interest and open minds and engage in dialogue. We need honesty, rigor and challenge. This will encourage learning, flexibility of response and creativity and help in solving problems and deciding the most appropriate way forward." - Making a Difference: Strategies and Tools for Transforming Your Organization by Bruce Nixon

In his book The Art of the Strategist , author William A. Cohen, PhD describes in detail ten principles for strategic success:

1. Define and commit fully to a set of strategic objectives.

2. Analyze and move forward quickly – don't sit there and wait for the ideal conditions to unfold before launching your strategic initiatives.

3. Clearly understand your competitive advantages and focus your resources into these competencies for strategic success.

4. Push hard on the things that are opportunistic to your organization in relation to the competition – move on your strong points before competitor's erode them away.

5. Don't be afraid to make some bold moves – experiment to keep competitors off balance.

6. Keep the organization simple so you can execute. Overly complicated structures and systems will impede strategic success.

7. Don't forget to develop some exit or alternative strategies since your current strategies will invariably run out of gas.

8. Take an indirect path to reaching your strategic objectives. For example, you may need to partner with some unfamiliar companies to reach your objectives.

9. Distinguish the cost benefit of going to market before your competitors. Timing is an important element, but you could get burned with first mover advantage. Pioneers often suffer large losses, paving the way for others to follow on the heels of the so-called first mover advantage.

10. Don't bail out too soon on your successes. Mature and modest success is a lot easier to manage than short-lived success.

Finally, here are a few key points to consider for effective strategizing:

- Strategies that have some original ideas, giving some distinction to the organization apart from the competition can be more value-added than a strategy that simply goes head-to-head against the competition on their terms.
- Strategies that imply a need to change or improve can be more value-added than a strategy that rarely changes what the organization is currently doing.
- Strategies that are easy to understand can be more value-added than a strategy that is complex and fails to take advantage of the resources that the organization has.
- Strategies formulated in isolation of stakeholders can be risky, superimposing dramatic changes upon others. Strategies must fit with others who have an interest in the strategy.

“For vision and strategy to be motivating and spark people's imagination it has to be challenging yet at the same time it has to be attainable. If the reaction is, ‘Yes, of course we can do that,' the target is probably not challenging enough. If the reaction is, ‘Not a chance in hell,' it has probably overshot the goal. If it is, ‘Can we do this? Well, perhaps we can . . .,' it is probably about right.” - The Innovative Wave: Meeting the Corporate Challenge by Bettina Von Stamm

Value through Innovation

Peter Drucker, the father of modern management once declared that the one core competency every organization must have is the ability to innovate. One of the reasons innovation is so critically important is because of change. With change, you are forced to innovate and you can elect to be reactive, forcing yourself to innovate (change what you are doing) or you can be pro-active, purposely seeking to innovate so as to control the changes forced upon you. As you might expect, the latter, the deliberate pursuit of innovation is the “value added” option.

So how do we create innovation? Start by fueling innovation through ideas. Ideas bring about innovation and ideas are fueled by creativity. Creativity emerges from people with varied skill sets, working together to spark innovation from one another. One ingredient behind creativity is having the right environment. People need to feel they can raise questions and take initiatives for innovation. The combination of competent people and the right environment is a powerful driver for creativity and innovation.

One common approach to innovation is through new product development. There's nothing wrong with redesign of products and services. However, you shouldn't confine innovation to this single area. For example, innovation can take place by changing the customer mix, adjusting the business strategy, rethinking how you apply your core competencies and managing complex differently. There are numerous areas where innovation can take place.

The timing of innovation can be important. The best time to pursue innovation is when you least need it! Since innovation is not easy to come by, it's best to pursue innovation when all is going well. You do not want to find yourself trying to force innovation during bad times or especially, during a crisis. You need time to test alternatives, run pilot programs, and discuss “lessons learned” before full-scale implementation of new ideas can be launched.

In his book Idea Power: Techniques and Resources to Unleash Creativity in Your Organization , author Arthur B. VanGundy outlines seven important factors for creating a climate for innovation:

1. Risk Taking – Any change requires some acceptance of risk.
2. Autonomy – Creative ideas are best generated when there is some degree of freedom of thought.
3. Performance / Reward – You must link rewards to specific performance.
4. Tolerance of Differences – An innovative climate recognizes that everyone is not alike and innovation works when everyone can express their ideas.
5. Top Management Support – Creating an innovative climate begins at the top, not at the bottom.
6. Initiating and Encouraging Ideas – Innovation requires a continuous flow of ideas – lifeblood of the organization.
7. Positive Response – Innovative ideas should receive strong positive response, not just passive encouragement.

Another powerful driver behind innovation is comparing what you are doing against others. Study the ideas of your competitor's, other companies, monitor business innovation on a large scale and see how you can adapt it to your organization. The best ideas that fuel innovation usually come from existing ideas. This is how the Japanese captured market share in the United States .

"It's OK to borrow an existing idea. The genius comes in adopting it for your needs:

• What could you adopt?
• What could you substitute in the approach, materials, ingredients, or appearance?
• What could you combine with an existing idea?
• What could you magnify or minimize?
• How could you put it to other uses?
• What could you eliminate?
• What could you reverse?
• What could you bring back?

And the best news of all – you can do it! Are you ready to borrow the best of existing ideas?"

- IdeaWise: How to Transform Your Ideas into Tomorrow's Innovations by Steve Rivkin and Fraser Seitel

In conclusion, most business experts seem to agree, innovation is what drives business growth. Over half of all growth in the United States comes from new products and services. We now see books titled: If It Ain't Broke, Break It – emphasizing the need to jump start innovation or in Tom Peter's book The Circle of Innovation – the transformation of the CEO into a Chief Destruction Officer. Two major drivers behind innovation are creativity and existing ideas. Creativity involves risk and the acceptance of failure while ideas are usually a function of watching and learning from others, finding ways of how you can apply and fit the best ideas of others into your business.

" . . . the greatest rewards go to companies that create new business models – ideas that spark new sources of revenue based on changing technology, demographics, and consumer habits. By definition, new business models destroy old ones, which is why creating new wealth is a threat to every traditional, unimaginative business. Never before have strategy life cycles been shorter and has market leadership counted for less. Call it the First Law of the Innovative Economy: Companies that are not constantly pursuing innovation will soon be overwhelmed by it. Strategy innovation is the only way to deal with discontinuous – and disruptive – change." - On Creativity, Innovation, and Renewal , edited by Frances Hesselbein and Rob Johnston

Value through Ethical Behavior

There is a growing body of knowledge to indicate that organizations that act in a socially responsible manner, following high ethical standards will in the long-run outlast and outperform companies that pursue profits at all costs. This connection between value and ethics has been around for a long-time, but several studies have confirmed it:

- "The financial performance of companies stating a commitment to ethics is better than those that didn't based on the annual rankings of companies." – Business Week Magazine
- "Of the 87 companies where an ethics code was clearly stated, the average Market Value Added (MVA) was 2.5 times larger than those not mentioning a code of ethics or conduct." – Corporate Performance is Closely Linked to Strong Ethical Commitment by Dr. Curtis Verschoor
- "Companies that routinely practice high business ethics and principles also attract the highest quality recruits and retain employees longer." – Ethics Research Center

Therefore, the morality of management has a lot to do with the overall value system behind any organization. In his book Saving the Corporate Soul, author David Batstone outlines eight principles of ethical corporate performance:

1. The directors and executives of a company will align their personal interests with the fate of stakeholders and act in a responsible way to ensure the viability of the enterprise.
2. A company's business operations will be transparent to shareholders, employees, and the public, and its executives will stand by the integrity of their decisions.
3. A company will think of itself as part of a community as well as a marketplace.
4. A company will represent its products honestly to customers and honor their dignity up to and beyond a transaction.
5. The worker will be treated as a valuable team member, not just a hired hand.

6. The environment will be treated as a silent stakeholder, a party to which the company is wholly accountable.
7. A company will strive for balance, diversity, and equality in its relationships with workers, customers, and suppliers.
8. A company will pursue international trade and production based on respect for the rights of workers and citizens of trade partner nations.

"Truth be told, the corporate crisis is as much spiritual as it is financial. Yes, fortunes are won or lost on the ability to anticipate trends and create products that meet these demands. But capitalizing on innovation is not enough today. A company's success also hinges on whether in the eyes of its employees and the public it honors a common sense of justice."
- Saving the Corporate Soul by David Batstone

The marketplace and business are usually driven by "commercial" type decisions. However, people are not necessarily driven by commercial or business related values. Individuals and organizations need to take it upon themselves to set a moral compass that is not driven strictly by commerce. Businesses can take several steps to establish a moral compass – transparency and honesty in reporting financial results, assuming responsibility for bad decisions, sharing of wealth to all, service to community, humanizing the workplace, and other decisions of integrity.

"A value is a belief in action. It is a choice about what is good or bad, important or unimportant. Values shape behavior. Until a value is acted upon it remains an aspiration. Values are hard to detect; yet they underpin organizations like the foundations of a house. If the foundation is weak, then the house falls down."
- Unlocking Organizational Values by Dave Francis and Mike Woodcook

Ethics is about the choices we make – the wisdom we display through our decisions, and ethics ultimately defines how we want to live – the standards of acceptable behavior that tells the world what is right. When we do these "right things" we create strong, sustainable relationships with our stakeholders, creating positive value for everyone. Thus, the connection between value and ethics!

Finally, what success represents to the "ethical" business leader may contrast sharply with the typical business leader. The typical business leader is often pre-occupied with meeting the numbers, defeating the competition, and being on top. Ethics is more concerned with doing the right things, not looking at business in terms of profits and financial results, but creating a sense of dignity and prosperity for everyone touched by the business.

"Getting business's ethical house in order starts with people. Consider that ethical transgressions can occur on countless levels. As social psychologists, we look at two variables, the environment and the person. Consider how your ethical miscues can affect people – employees, colleagues, and superiors, suppliers, customers, internal regulators (lawyers, auditors, the board of directors), external regulators (government, interest groups, and the like), shareholders, or the public at large in your community. You can affect any or all, separately or combined, consciously or not. And you can have an impact on how they think of you in numerous ways – through corporate citizenship, product quality, your business plans and strategy, how openly and candidly you communicate, by the clarity of your business reviews and reports – internally or externally, by the transparency of your financial and other public statements, and you certainly have an impact on your image if you commit premeditated fraud or deceit, or even violate criminal laws. These can be acts of commission – or acts of omission, venial – in the moral theologian's view – or moral." - The Ethical Challenge: How to Lead with Unyielding Integrity, Edited by Noel M. Tichy and Andrew R. McGill

Value through Leadership

People invariably drive performance and given the right leadership, people will perform at very high levels. Understanding the dynamics and attributes behind leadership is critically important to overall performance for any organization. One of the best ways to understand leadership is to connect it to value-creation. For example, leaders who comprehend value take into consideration the needs and values of all stakeholders. They balance each stakeholder when making a decision – what's best for maximizing value for everyone. This tends to contrast sharply with non-value based leaders who are overly bottom-line driven, focused on a select group of stakeholders, failing to recognize how a decision positively impacts one group at the expense of another.

"There are two kinds of leaders: the ordinary ones and the visionary ones. Only the latter are truly successful." – The Visionary Executive: Strategic Planning for the New Business Leaders by Michael Z. Brooks and William Mills

In his book Value Leadership , author Peter S. Cohen outlines seven principles of value leadership:

1. Value human relationships: Treat people with respect so they achieve their full potential consistent with the company's interests.

2. Foster teamwork: Get people, particularly those with different functional skills and responsibilities, to work together to advance the interests of the corporation.

3. Experiment frugally: Harness accidental discoveries to create value for customers and partners.

4. Fulfill your commitments: Say what you intend to do; then do what you say.

5. Fight complacency: Weed out arrogance.

6. Win through multiple means: Use strategy to sustain market leadership.

7. Give to your community: Transfer corporate resources to society.

Leaders create value through their ability to bring about change through other people. Perhaps this is the best definition of leadership: The capacity to create change in others. Creating change requires that you effectively reach people. One of the drivers behind making this happen is something called emotional intelligence. The ability to convey things in a passionately or emotional way gets people to commit to the cause. High emotional intelligence also enables leaders to read people and situations better.

"Lasting success lies in changing individuals first and then the organization follows. An organization changes only as far or as fast as its collective individuals change. Unlocking individual change starts and ends with the mental maps people carry in their heads – how they see the organization and their jobs. And if leaders cannot change individual's mental maps, they will not change the destinations people pursue or the paths they take to get there."

- Leading Strategic Change: Breaking through the Brain Barrier by J. Stewart Black and Hal B. Gregersen

One of the greatest challenges confronting any leader is bridging the gap between strategy and getting people to execute. Leaders direct people to focus on the right strategic issues. Too often people cannot identify with an organization's strategy and likewise, too often leaders are disconnected from the realities that people must face within the organization. If the leader can properly bridge this gap (strategy vs. organizational capacity), then the leader should be able to create value.

An organization must be managed in such a way that a strong dialogue takes place between the leader and its people. If the right people are engaged, then everyone should be able to cut their way through the strategic jungle. If leaders fail to engage people in strategic execution, then creating value through leadership will be exceedingly difficult. Although it is true that most people are not good strategic thinkers, it is also true that people want to contribute to a larger purpose that only the leader can convey. Therefore, communication is at the cornerstone of creating value through leadership. And given great communication, leaders can close the gap between strategy and strategic execution.

"Above all, leadership communication entails nuturing and maintaining a workplace environment in which communication flows freely and quickly in all directions with minimal distortion or lag time. The leader of an organization is automatically the designated chief communication officer and is accountable for all communication in the organization – not only his or her own, but that of the entire workplace community. As such, communication demands a deeper understanding, and some new perspective." - The Leader as Communicator by Robert Mai and Alan Akerson

Value through Marketing

For any organization that must compete for customers, there is a real need to have a viable and strong marketing effort. Unfortunately, marketing may not get the attention it deserves by senior level management. Given the new challenges confronting most organizations, finding and keeping customers has become mission critical. And traditional approaches to marketing, such as introducing more products or increasing advertising, may not add value. A "value-added" approach to marketing is much more complex than traditional approaches.

"In today's world, customers are scarce – not products – and classic marketing needs to be deconstructed, redefined, and broadened to reflect this new reality. It calls for a fundamental rethinking of corporate strategy to enable the ongoing creation and delivery of superior value for customers in both the marketplace and the market space. And it appoints marketing as the lead driver in shaping and implementing this strategy."
- Market Moves: A New Approach to Profits, Growth, and Renewal by Philip Kotler, Dipak C. Jain, and Suvit Maesincee

One way to get more out of marketing is to elevate marketing into your strategic process. In fact, your strategy should be dominated by marketing since customers drive so much of what a business does. And when you create more value for your customers than your competition, then you have a more sustainable future.

Another key part of creating value through marketing is through alliances and partnerships. In order to execute across the entire marketing chain (supplies, public relations, advertising, product innovation, etc.), you must align yourself with some critical partners. Just like building a great sports team, you need highly talented players that can execute on their part of the marketing mix. This will require strong collaboration within everyone, connecting the knowledge in a way that marketing is now fully integrated as opposed to fragmented silos of activity. Fragmented pieces of marketing are less value added since too many errors and miscommunication problems take place in the absence of a single, cohesive effort. Once again, you can think of it in terms of a sports team where everyone on the field clearly understands how they must execute.

"Marketing is a matching process, one that pairs the capabilities of a company and the wants of the customers. What is the unique value that you will create? What steps will you need to take to create this unique value? What steps will you need to take to insure that you continue to have a competitive advantage?
- Marketing Plans that Work by Malcolm H.B. McDonald and Warren J. Keegan

Finally, your marketing effort will need to have processes in place to monitor and react quickly to changes demanded by your customers. One way to accomplish this is to fall back on your "integrated" marketing chain since this is an invaluable source of knowledge. By tapping into this knowledge, you begin to "manage" the entire process. This is commonly referred to as Customer Relationship Management or CRM. CRM is the process by which you learn about opportunities on how you can add value to customers in the chain (supplier, vendor, end-user of products and services). And as long as you can create and build more value, then you are creating value through your marketing effort.

"Customer relationship management (CRM) can be the single strongest weapon you have as a manager to ensure that customers become and remain loyal. Implementing CRM is nonnegotiable in today's business environment. Whether your customers are internal or external, consumers or businesses, whether they connect with you electronically or face to face, from across the globe or across town, CRM is your ticket to success."
- Customer Relationship Management by Kristen Anderson and Carol Kerr

Value through Information

When you attempt to create value, you have to make a choice between alternatives and this requires reliance on information. Understanding how to create "quality" information is paramount to decision making. One way to improve the quality of information is to make sure there is a strong flow of external sources – looking at market trends, surveying the customers, pursuing new technologies, and of course, competitive intelligence. These external sources provide the "reality checks" we need to remove internal bias, common to so many organizations.

"For managers to produce information required for their work, they have to address two broad questions:

1. What information do I owe to the people with whom I work, and on whom I depend? In what form? And in what time frame?
2. What information do I need myself? From whom? In what form? And in what time frame?

- Competing with Information: A Manger's Guide to Creating Business Value with Information Content, Edited by Donald A. Marchand

Another way to improve the quality of information is to look at your people. Information is how people communicate their knowledge so things get accomplished. Since information relies on people, it only stands to reason that the quality of information has a lot to do with the quality of people; i.e. the skills, expertise, training, experience as well as their communication skills. This can greatly impact the quality of information – improve your people if you want to improve your information.

The quality of information also follows certain characteristics. These characteristics can lend serious value to information. Here are a few examples:

• Up to Date – Information that is current usually has more value than old, outdated information.

• Accuracy – Some sources of information tend to have higher accuracy than others.
• Impact on Decision Making – Information that is useful to decision making will lend value to the organization.

One common problem in creating value through information is putting the information in front of the decision maker. This requires that people have access to information. Too often, organizations have fragmented silos of information, contributing to inconsistency in decision-making. Pulling all of these stovepipes of information together into one common repository can yield numerous benefits, such as: Faster response time by decision makers, better creditability with stakeholders (employees, customers, suppliers, etc.), improved accuracy through verification, and more value added through the application of analytical tools.

Obviously, technology plays a big role in making this happen – everything from better access to filtering of the information overload. Perhaps the single biggest technology behind the management of information is something called the Data Warehouse. The Data Warehouse pulls together all of the desperate databases, providing not only wider access, but also increased analytical capability through the understanding of relationships between all of this data. So if you are serious about creating value through information, you'll probably have to consider some form of a data warehouse.

"Capitalizing on the information a company owns about its customers, suppliers, and partners is now the value proposition for sustainable long-term growth. Better information, then, transforms business. Better information also transforms the terms of collaboration between businesses."
- The Value Factor by Mark Hurd and Lars Nyberg

Finally, the roadmap to value through information is creating systems and processes for learning. Author Peter Senge popularized this concept in his book The Fifth Discipline – namely that we all need to become systems thinkers, having the ability to fit the pieces together. This entire process is commonly referred to as the Learning Organization. And this is a big factor behind creating value through information! And when coupled with the right people and the right technology (such as a data warehouse), information can add a lot of value for anyone touched by the information.

"The knowledge economy stands on three pillars. Knowledge has become what we buy, sell, and do. It is the most important factor of production. The second pillar is a mate, a corollary to the first: Knowledge assets – that is, intellectual capital – have become more important to companies than financial and physical assets. The third pillar is this: To prosper in this new economy and exploit these newly vital assets, we need new vocabularies, new management techniques, new technologies, and new strategies. On these three pillars rest all the new economy's laws and its profits."
- The Wealth of Knowledge by Thomas A. Stewart

Economic Value Added

What is Economic Value Added (EVA)?

Have you noticed that the stock prices of many companies (especially internet stocks) seem to rise rapidly despite large reported losses on their Income Statements. How can values go up, up, and up with such low earnings on the Income Statement? This question has raised serious concerns that Net Income has little to do with the values of companies. So why the disconnect? Well, net income is derived from past events on a short-term basis while values of companies are derived from future events over the long-term. Consequently, managers are looking for better measures of financial performance. In recent years, such a measurement has emerged. It's called **Economic Value Added** or EVA.

The basis of EVA resides in something called Economic Income. Economic Income is a better measure of value-creation since it takes a much longer view of what's going on. Unfortunately, calculating Economic Income isn't easy. For example, suppose you spend $ 10,000 on research and development. This should provide a long-term benefit to your organization. In determining Economic Income we will capitalize Research and Development while under traditional accounting, we deduct the full amount as an expense in arriving at Net Income.

In a much simpler form, EVA is calculated by taking Net Operating Profits After Taxes (NOPAT) and reducing NOPAT by your **total** cost of capital. Remember that your cost of capital includes both debt and equity. Cost of Capital is the cash flows that you spend to compensate your investors for the risks they incur when they lend you money or buy stock in your company. The resulting amount, NOPAT - Cost of Capital, is called EVA. If it's positive, this indicates that you created x amount of value for the owners of your company. A negative EVA would imply that you destroyed x amount of value for the owners.

Numerous companies, such as Coke Cola, have made EVA their key management program to drive value-creation. So does EVA really work? Well, that depends upon your business. It appears EVA is a good improvement to traditional financial measurement when a company's capital structure is heavily invested in real assets with relatively low debt loads (such as utilities). However, if your business is based on intangibles such as intellectual capital in a fast growth environment (such as technology companies), than EVA will be less useful.

My recommendation is to give EVA serious consideration due to the major distortions within traditional accounting. However, since cash flows are the real source of value-creation, you need to take EVA with a grain of salt. And don't forget that value-creation comes from lots of things that have little to do with financial measurement.

Four Steps to Calculating EVA

EVA or Economic Value Added is a financial measurement of how much value was created or destroyed for the reporting period. The following example illustrates a four step approach to calculating EVA:

Step 1: Calculate NOPAT (Net Operating Profits After Taxes)
Gross Profits (Sales - Cost of Goods Sold) of $ 100,000 less Depreciation & Amortization of $85,000 = $15,000 less income taxes @ 30% = NOPAT of $ 10,500.

Step 2: Determine Amount of Capital Deployed
Net Working Capital of $ 20,000 + Net Fixed Assets of $ 60,000 = Total Capital Deployed of $ 80,000.

Step 3: Calculate Your Weighted Average Cost of Capital
We will assume that the Capital Asset Pricing Model was used for calculating an equity cost of capital of 14% and that market weights show 65% debt and 35% equity. Cost of Equity x Market Weights or .14 x .35 = .049. Cost of Debt x Market Weights or .09 x .65 = .0585. This gives us Weighted Average Cost of Capital of .1075 or 10.75% (.049 + .0585).

Step 4: Calculate Capital Charge to NOPAT & EVA
Total Capital Deployed (Step 2) was $ 80,000 x Weighted Average Cost of Capital (Step 3) of .1075 = Total Charge for Cost of Capital $ 8,600. Now take NOPAT (Step 1) which was $ 10,500 Less Charge for Cost of Capital of $ 8,600 = Economic Value Added or EVA of $ 1,900.

Making Economic Value Added (EVA) Work

One of the biggest problems with measuring the creation of value is that it's all over the place. Value comes from so many things: Customer service, efficient operations, great products, intellectual capital, etc. And if you expect to drive value from these sources, then you have to go way beyond financial measurements like EVA. That is why professionals like myself are big advocates of *balanced scorecards* and *competitive intelligence*. Since EVA is a "financial" type measurement and since value-creation has so many sources, EVA can't possibly be the sole driver behind value-creation.

Another problem with EVA is cost of capital is already recognized for highly leveraged companies. When debt is high, your cost of capital shows up on your Income Statement; i.e. outstanding debt requires interest payments. These payments show up on your Income Statement as interest expense. Also, your returns on assets are not easily measured. Suppose your organization is a knowledge based service company, than measuring the true returns on all assets becomes difficult. The "intellectual assets" within your organization are not measured and reported anywhere, but they can be the single most important asset you have for creating value.

Despite its limitations, EVA warrants serious consideration by many organizations; especially if your organization is relying on traditional financial measurements, such as ratio analysis. EVA reports the real economic profits of your organization. This is accomplished by forcing your organization to consider the entire cost of capital.

In order for EVA to work, you will need to consider the following:

1. Build an EVA Model that fits your organization. For example, what adjustments are needed to capital? What business units are included in the calculations? What adjustments do you make to NOPAT (Net Operating Profits After Taxes)?
2. Determine how you will apply EVA. What business units will you measure? What levels of management will be subject to EVA?
3. Determine how you will implement EVA. How will EVA be reported? How do you get the organization to "buy in" on the idea of EVA? Who should receive training in EVA?
4. Determine how EVA will impact your company. Who is the most responsible for generating EVA? Should you link compensation of key officers to EVA?

How EVA is introduced and implemented will be critical to its success. Remember EVA can create some uneasiness among your managers. Having top management as the champions of EVA will go a long way in making EVA work. The bottom line is simple: Management must increase shareholder wealth and EVA can represent a good metric to add to your existing financial measurements (Return on Gross Investment, Return on Equity, etc.). Everyone involved in Financial Management should be conversant with EVA.

Risk Management

Step 1 in Risk Management: Take a Risk Profile

All organizations are faced with risks, ranging from destruction of assets by fire to lawsuits from customers. So how do you manage all of these risks? Well the first step in managing risks is to complete a *Risk Profile* of your organization. A risk profile assesses your risk by asking numerous questions. For example, does your business operate overseas? If yes, you may be exposed to exchange rate risks. Does your company execute contracts on a regular basis? If yes, do the contracts limit your liabilities? Are sales within your company largely dependent upon a single customer? If yes, you may be exposed to high levels of business risk.

Besides asking lots of questions, a risk profile is also developed by looking at past insurance claims and lawsuits within your industry. Physical inspection of facilities can uncover possible problems such as theft and employee injury. Interviewing employees can help identify several types of risks. Once you complete the Risk Profile, you will have a good understanding of different risks that apply to your organization. Your next step is to categorize risks so that you can properly manage them.

Step 2 in Risk Management: Categorize Your Risks

After you have completed a Risk Profile of your organization, the next step in risk management is to categorize your risks. Risks are categorized into four areas according to significance and probability:

Significance to Organization	Probability that Risk will occur	Basic Approach to Managing this Type Risk
HIGH	HIGH	Try to avoid these types of risk
LOW	HIGH	Implement procedures and policies to reduce
HIGH	LOW	Use insurance to spread the risks
LOW	LOW	Accept these types of risks

Now that you have categorized your risks, you can implement a formal risk management program. If you have risks that will materially impact your organization and there is a high probability of occurrence, than you want to take steps to avoid these types of risks. For example, some Japanese manufacturers have incurred significant losses from foreign currency exchanges with the United States. In order to avoid these risks, manufacturing operations have been transferred over to the United States.

Some risks are likely to occur, but have little impact on your overall operations. For example, employee injuries are common, but rarely do they result in significant losses. A worker safety program can reduce this type of risk. You can use insurance for risks that are significant, but rare in occurrence. Finally, if you have risks that are not material and infrequent, you will implement a risk retention program; i.e. you will accept these types of risks. Most companies calculate an assigned value to this last category to determine their overall exposure. One final point: Since risks will change over time, you will need to go through this process on a regular basis.

Using Insurance to Manage Risk

One of the most common ways of managing risks is to use insurance. Once you have categorized your risks, you need to seek insurance on those risks that can be significant in your operations, but have relatively low probabilities of occurrence. Insurance is used to share losses associated with property, income, and liability. You can either purchase separate policies for each type of loss or you can use a commercial package to cover a range of losses. Commercial packages are usually cheaper than a collection of separate policies.

So what kinds of insurance are available? Well first you will use property insurance to protect your assets against damages and losses from various events (floods, fire, etc.). Property insurance with "all risk" is usually preferred since it's sometimes hard to predict what kinds of events will occur. Crime insurance is sometimes added if you have assets located in areas subject to theft and vandalism. General Liability insurance is used to protect your organization against claims from injured parties. Product Liability insurance is used to protect against faulty workmanship. Professional Liability insurance is used to protect engineers, CPA's, and other professionals against liability due to errors and omissions in their work.

If your business is subject to major interruptions from floods, hurricanes, and other natural events, than you may want to consider Business Interruption insurance. Business Interruption insurance provides your organization with a base level of cash until you can get up and running again. If you have key personnel that are important to your organization, than you should consider life insurance on these employees. Finally, if you have concerns that your separate insurance policies may not cover all of your exposures, than you can execute an Umbrella Policy to catch the unique items not covered by other policies.

Managing Foreign Exchange Rate Risks

When you conduct business overseas, you will have to convert currencies involved at some prevailing exchange rate. The price of one country's currency in terms of another country is called the exchange rate. When the currency of one country depreciates (drops in value), there will be a corresponding appreciation of value in another country's currency. Depreciation occurs when it takes more currency to purchase the currency of another country. Appreciation is just the opposite; the currency is able to purchase more units of the other country's currency. Since most currencies are valued according to the marketplace, there are constant changes to exchange rates. This gives rise to exchange rate risk.

There are several ways to reduce exchange rate risk. Two popular approaches are hedging and netting. Hedging is where you buy or sell a forward exchange contract to cover liabilities or receivables that are denominated in a foreign currency. Forward exchange contracts offset the gains or losses associated with foreign receivables or payables.

A very popular form of hedging is the Interest Rate Swap. Interest rate swaps are arrangements whereby two companies located in different countries agree to exchange or swap debt-servicing obligations. This swap helps each company avoid the risks of changes in the foreign currency exchange rates. Due to the popularity of interest rate swaps, most major international banks offer interest rate swaps for organizations concerned about foreign exchange rate risks when making interest payments. The costs charged by banks for interest rate swaps is relatively low.

Another solution to foreign exchange rate risk is the use of netting. Netting is the practice of maintaining an equal level of foreign receivables against foreign payables. The net position is zero and thus exchange rate risk is avoided. If you expect the currency to depreciate in value, than you should hold a net liability position since it will take fewer units of currency to pay the foreign currency debt. If you expect the currency to appreciate in value, then you would want to have a net receivable position to take advantage of the increased purchasing power of the foreign currency.

There are other vehicles for dealing with exchange rate risk, such as option hedges and other types of derivatives. However, the costs and risks associated with these types of arrangements can be much higher than a simple approach such as the interest rate swap.
If you have exchange rate exposure, then take a look at simple hedges and netting as ways of avoiding foreign exchange rate risk.

Controlling Costs

A Better Approach to Cost Control: ABC

When it comes to controlling costs, most organizations control costs by general ledger account; i.e. they look to their Income Statement. So when you have to cut costs, you look at your expenses and say to yourself: "Payroll is $ 100,000 and utilities is $ 5,000; we can't cut off our utilities, but we can sure cut payroll."

This short-sided approach to cost control often leads to the destruction of value within the so-called value chain. When you cut people, the activities they perform may still be there, but no one's around to perform the activity. So you end-up creating black holes in the organization that destroys employee value. Once you've destroyed employee value, this leads to poor customer service and hence, the destruction of customer value. Now that you've lost your customers, this translates into the destruction of shareholder value. So you end-up destroying value within the entire value-chain: Employee, Customer, and Shareholder.

A better approach is to control your costs by activity. Under this approach, you now look at your expenses by activity; such as costs to process customer orders, costs to run payroll, costs to recruit new employees, etc. The key is to reduce costs that fail to serve internal or external customers. You can easily do this by simply focusing on RE-type activities. For example, Retype the letter, Re-inspect the pipe, Re-enter the accounting entries, etc. Try to eliminate RE-type activities and you will improve your process immensely and cut costs at the same time.

The formal system for controlling costs by activity is referred to as **Activity Based Costing**. Activity Based Costing (ABC) is not easy to implement, but once working it can open your eyes to a whole new approach to cost control. You leverage ABC information by making management decisions - this is called Activity Based Management (ABM). And once you have ABM working, you can implement Activity Based Budgeting and ultimately build a model to look at both costs and revenue drivers. For now, I highly recommend that all organizations think in terms of activities, not in terms of general ledger account. Otherwise you run the risk of destroying value within the value chain.

Why Implement Activity Based Costing?

Whether you realize or not, your cost control system may be becoming more and more distorted. At the heart of this distortion is an enormous escalation in overhead costs. According to Robin Cooper, a well-known authority on cost control, many organizations are experiencing *super-variable costs* within fixed overhead. For example, support staff and programming are exploding for many companies with projects like Enterprise Resource Planning. These types of costs are often classified within traditional cost systems as administrative overhead. Traditional systems allocate these costs based on a single relationship to numerous cost centers. Some experts refer to this traditional approach to cost allocation as "peanut butter" accounting. The end result is an enormous distortion in cost allocation to various cost centers.

Activity Based Costing (ABC) looks at relationships in allocating and reporting costs. Consequently, many of the distortions occurring in traditional cost systems are eliminated due to an itemized allocation approach. Additionally, the ABC Model can be designed to provide profit information by customer, by product, etc. This in turn leads to be better pricing of products and services. It also results in increased profits since resources (such as marketing staff) are redirected where the profits are the highest.

ABC can also fit with other re-engineering and information improvement projects. Software vendors, like ABC Technologies (www.abctech.com), now have integrated their software with ERP applications. Implementing ABC isn't easy since it requires extensive analysis of activities, building a three layer cost model, and maintenance after implementation. However, given the increased distortions in traditional systems and with so much emphasis on company improvement projects, ABC needs to be given serious consideration where process improvement is critical.

Performance Measurement

The Basic Foundation Behind a Performance Measurement System

A good performance measurement system can change your entire organization. However, your organization must be willing to accept change. If upper-level management supports long-term improvement and your company is receptive to change, than a performance measurement system needs to be considered. A performance measurement system is based on measuring areas that are critical to your future success.

A good performance measurement system strikes the right balance or mix of key performance indicators. This requires that you properly identify those things that need to be measured on an enterprise-wide basis. The mix of performance indicators should not be so extensive that your system will be overly complicated. Try to keep your indicators to four or five main areas; such as customer service, market share, innovation & development, and financial performance.

Once you have the right mix of performance indicators, than ask yourself two very important questions: Can we measure the indicator and can we report the indicator? You have to be able to measure the critical area to control it. And you must be able to report your measurement results if you expect to take action in the area being measured. If your system can't pass these two questions, than you run the risk of a system whose costs exceeds the benefits. If your system has passed these two critical questions, than it's time to start building a prototype for testing and refinement.

It is extremely important to get feedback from users in the design of your system. In order to ensure users are happy, it is sometimes better to work backwards; i.e. design the outputs for the users first and than work backwards designing the actual system. The best performance measurement systems distribute results on-line and facilitate user interaction (such as On-Line Analytical Processing). But even if you can't have an automated system, remember a basic performance measurement system in the form of reports is a lot better than no system at all.

Design Steps in Building a Performance Measurement System

If you have decided to implement a performance measurement system (PMS), here are six basic steps you will need to consider in designing the system:

1. Bring together all stakeholders; i.e. everyone who has an interest in the PMS. The purpose of this first step is to build consensus on what should be accomplished from the PMS. What are the needs of your organization? A cross-functional team needs to be formed for directing the design of the PMS.

2. Next, your cross-functional team will need to formulate a plan for analyzing activities, collecting data, communicating to users, etc. Your main objective is to identify areas that need to be measured. Start by looking at how your business is organized. For example, if your business is organized around assembly plants, than your PMS should follow this path.

3. Once you have an understanding of what needs to be measured, you have to collect the data that will be used for decision making. It's usually best to have one member of the cross-functional team for each area that will be measured. For example, if you are collecting operating data, you should have an operating person on your cross-functional team. The purpose of step 3 is to determine how you will manage the data within your PMS. How often will the data be needed? Can it be measured and reported within the PMS?

4. The cross-functional team must select a test site within your company. Here you will run pilot tests to determine the feasibility of a PMS. When you select a site, make sure you are dealing with activities that can be measured. You should select a site that has room for improvement and current employees are not happy with the current system. However, you need a test site that can generate reliable data. So the existing system must be reasonably sound.

5. At the test site, you will need to collect lots of data. Several questions must be addressed. How easy is it to collect the data? How big should the test area be? How many people should be involved? Once again, you need to determine the feasibility of a PMS, the costs versus the benefits. Make sure you have support from users at this stage of the process. If not, you may need to go back to the drawing board.

6. Once you have collected and analyzed the data at the test site, you need to present the results of your performance measurements to management. Make sure you present the outputs in a useable and easy-to-understand format. For example, operating people will want performance information presented differently than marketing people. You must tailor the information to fit the user.

Obviously a lot more planning and detail goes into designing a new system. This article has touched on the very basic steps within the process. Finally, keep in mind that many new projects will fail due to:

- Lack of support from upper-level management (single biggest reason for failure).
- Inability to form a good cross-functional team.
- The PMS doesn't fit the organization.
- The organization is not willing to change.

What are Critical Success Factors?

There are things that your organization must do right if you expect to survive in the future. These critical areas require constant care and attention on the part of management. According to John F. Rockart in the Harvard Business Review: "Critical success factors for any business are the limited number of areas in which results, if they are satisfactory, will ensure successful competitive performance for the organization."

Therefore, critical success factors represent performance areas that must meet expectations if the organization is to flourish. Measurements are used to track performance in each critical success area. Critical success factors are both internal and external. For example, comparison of budgets to actual would be internal while percent of market share would be external.

One way to identify critical success factors is to go through a strategic planning process. A second or complimentary approach is to conduct competitive intelligence research. Look at the success factors of your competition. Collectively, you will need to develop a set of critical success factors which serves as the foundation for your performance measurement system. Consequently, critical success factors are an important link between strategic plans and performance measurement systems.

Examples of Key Performance Indicators

Key Performance Indicators (KPI) are used in performance measurement systems such as the Balanced Scorecard. Examples of KPI's for specific measurement areas include:

Measurement Area => Customer Service (Price, Delivery, Support, Satisfaction)
Examples of KPI's => Price comparisons to competition, number of on-time deliveries, response times, customer complaints, number of product returns, customer survey results, service awards, etc.)

Measurement Area => Internal Operations (Efficiency, Costs, Production, Inventories)
Examples of KPI's => Cycle times, inventory turnovers, defect rates, plant utilization, targets met, unit cost compared to competition, overhead trends, etc.

Measurement Area => Innovation (New Products, Technology, R & D)
Examples of KPI's => Number of new products, number of patents, new technologies adopted, system improvements implemented, etc.

Measurement Area => Financial (Profitability, Growth, Value)
Examples of KPI's => Return on Equity, growth rate compared to industry growth rate, EVA, levels of operating cash flow, etc.

The ultimate purpose of KPI's is to drive future performance. The Balanced Scorecard provides the framework for capturing and reporting this performance.

Matching Financial Metrics with Strategies and Cycles

Traditional financial performance measurements are often applied uniformly to all business operations without regard to variations in strategies and / or stages within the business cycle. For organizations with diverse operations and different units or divisions, there is a need for different performance measurements since each unit has a different strategy. Forcing a one size fits all approach to performance measurement results in erroneous comparisons. Start with strategy and build measurements to fit strategies, not the overall organization.

Additionally, financial performance measurements need to consider the life cycle of a business unit. For early stages in the cycle, there is high growth, large investments and little or no working capital. Performance measurements need to focus on sales and market growth as opposed to immediate profitability. As the business stabilizes, growth slows down and the focus shifts to maintaining market share and sustaining the organization. Traditional financial performance measurements will now be employed, such as return on equity, return on assets, etc. The next stage in the cycle is maturity. All major investments have been made. Most investments are short-duration for maintaining the existing organization. The main emphasis is on cash flow; especially operating cash flows. Thus, performance measurements tend to emphasize cash flows for mature business units.

Performance measurements are not static. You have to review and revise measurements in relation to strategies and business cycles. The best managed companies seem to understand that some measurements are emphasized over others in relation to strategies and cycles within the life of an organization.

The Balanced Scorecard: Measuring Real Sources of Value

The dilemma facing most financial managers today is how do I drive value-creation within my organization? Many managers have decided to hang their hat on something called Economic Value Added. But can we really drive value by measuring only the financial parts of our organization? The answer is a resounding NO!

The real sources of value; i.e. those things that result in higher capacities for generating cash flow come from many things. They include great customer service, great products, extremely efficient operations and ultimately the greatest source of value resides in your ability to innovate. As Tom Peters has pointed out in his book <u>The Circle of Innovation</u>, innovation is what separates the men from the boys when it comes to value-creation.

So now that you understand the sources of value, how do you go about doing all of these things (great customer service, great products, innovation, etc.). Well you have to measure it and the way you are going to measure it is on something called the **Balanced Scorecard**. The Balanced Scorecard is a "balanced" approach to measuring those things that are critical to your future success. Key Performance Indicators (KPI) are established for your critical success factors, such as customer service. KPI's are reported in a dashboard format that resembles the dashboard a car.

Because balanced scorecards provide simple visual output, they often receive wide acceptance throughout the organization. For example, most balanced scorecards report results on gauges or dials with red indicating problems, yellow indicating caution, and green indicating acceptable performance. A series of needles on the gauge will show trends in the KPI. Comments can be added by users to help explain results and indicate what actions will be taken to improve performance.

By the year 2005, over half the Fortune 1000 companies in the United States will have implemented a Balanced Scorecard. If you want to measure and drive value, a Balanced Scorecard is possibly the best measurement system you can implement.

The Power of the Scorecard

The Balanced Scorecard implies a performance measurement system. However, as Kaplan & Norton have pointed out, the Balanced Scorecard is a management system, not a performance measurement system. The reason is due to the fact that the Scorecard deals with strategies, the real source of increased values for an organization. The problem is that most organizations fail to successfully implement their strategies.

Most people within an organization are way too focused on tasks and activities with little or no focus on strategizing. Even upper level managers fail to spend sufficient time on strategizing. According to one study, executive managers spend less than 50% of their time on strategic planning type activities. When you poll workers within an organization, you will find that less than 10% have any understanding of the organization's strategies. Is it no wonder that most organizations fail to create value through strategizing.

Enter the Balanced Scorecard. The Balanced Scorecard transforms an organization into a knowledge driven organization. Strategies are now communicated throughout the entire organization in a very precise and specific metric format. This allows people to easily identify with the strategies of the organization. Everything is now linked together, working from the same plan as opposed to scattered pockets of knowledge working in all directions. When you embed everyone into one system, the organization can respond quickly to changes in the marketplace. And since strategy is everyone's business, you have a tool for communicating strategy in terms that people can relate to. Balanced Scorecards unlock and release many of the solutions that people have for meeting strategic goals and objectives. This is why Balanced Scorecards are so powerful in helping an organization create higher values.

A case in point often cited by Kaplan & Norton is that of Mobil Oil. In 1993, Mobil adopted the Balanced Scorecard as a tool for integrating and communicating its strategies. Mobil's performance was ranked dead last in 1993. Two years later, Mobil launched its strategies in conjunction with the Balanced Scorecard. By 1996, Mobil Oil had reached record performance. This performance was repeated in 1997 and once again in 1998. As long as organizations have the ability to develop good solid strategies, the Balanced Scorecard can be the tool for implementation. If you want to create higher values, you must engage in strategizing and once of the best ways to implement strategies is through the Balanced Scorecard.

Balanced Scorecards for Non Profits & NGO's

Since strategies are critical to the success of non profit organizations (NPO) and non governmental organizations (NGO), balanced scorecards represent the central management system for running the NPO / NGO. One of the biggest difficulties for NPO / NGO's is to restrict the scope of strategic objectives. NPO & NGO's will typically have an overall strategy that tries to do too many things with too few resources. Therefore, the first step for building an NPO / NGO Balanced Scorecard is to make strategic choices about what the NPO and NGO can realistically hope to accomplish. Remember, it is better to have a few successes than a lot of failures.

Additionally, existing legacy systems are often riddled with numerous measurements and reports, making the organization focus on the wrong things. Although some of these controls may be important, they should not be part of your balanced scorecard. The Balanced Scorecard should be based on the vital areas within the strategic plan. Once a realistic strategic plan has been developed, you can establish perspectives for the scorecard.

Perspectives for NPO / NGO's can differ significantly from private sector scorecards. For example, the Customer Perspective is usually the most important perspective for an NPO / NGO. Customers represent the essence of why an NPO / NGO exists. Additionally, many NPO / NGO's will have two customer perspectives; customers who contribute resources to the NPO / NGO and customers who receive the services and products of the NPO / NGO. In some cases, customers who receive services will not pay for the services. Payment is made from another source. Also, customers can under-score every perspective within the Balanced Scorecard. For example, the City of Charlotte, North Carolina has a balanced scorecard that includes Community Safety, Transportation, and Economic Development as perspectives. All of these perspectives have customers. Therefore, the customer perspective for NPO / NGO's is considerably different than commercial businesses.

Whereas the Financial Perspective tends to be important for commercial businesses, financials is not as critical for NPO / NGO's. For example, United Way's balanced scorecard places the customer perspective at the top. Internal processes, such as improving efficiency, increasing capacities of local United Way's, and delivering services, fall below the customer. The Financial Perspective is listed at the bottom since it does not represent a major strategic objective; financial activity is the lubricant or enabler for operations, but not a critical strategic objective.

Probably the biggest challenge for NPO / NGO's is to align existing resources with the strategic themes that have emerged from the strategic planning process. Alignment will usually flow in a similar fashion to commercial business scorecards. You start at the top where overall organizational management and strategies occur. Second, you move down to the operating units that will deliver the products and services in accordance with the strategic plan. Next, support services must design their scorecards to meet the needs of the operating units. Finally, scorecards are developed at the individual level based on the three layers above.

Since NPO / NGO's are facing more and more demands with fewer resources, it has become increasingly important for NPO / NGO's to be very selective in their strategies; focusing on those areas that will have the biggest impact. Balanced Scorecards are only as good as the strategic themes of the NPO / NGO. And the Balanced Scorecard will tell the NPO / NGO how well it is doing with its strategic themes. If performance is poor, it may be necessary to re-strategize and decide which initiatives should be continued and which should be discontinued. Balanced Scorecards represent a system of communication, providing feedback in relation to the strategic map of the NPO / NGO. The better the strategic map, the better the results you will get from the Balanced Scorecard.

The Basics of Benchmarking

The use of benchmarking can provide an objective way of measuring performance against the competition. Benchmarking is based on finding a comparable activity and determining how well you are doing. Comparisons can be both internal and external; i.e. you can compare performance between similar departments or divisions as well as compare internal to external benchmarks.

Benchmarking provides several benefits, including better understanding of the competition, better performance, and objective evaluations of performance based on real examples. One way to leverage benchmarking is to develop cost data and cost the process or activity that is being benchmarked. This provides a "perfect world" view of the activity since all costs not related to the activity are removed; especially any abnormal or unusual costs. This view of costs is becoming increasingly important since management must understand costs under a perfect scenario if the company expects to compete in the global marketplace. Additionally, management and investors are starting to push for perfection because of programs like Six Sigma.

The basic process for setting up benchmarks will usually consist of:

1. Identify and understand the function or process that needs to be benchmarked. Determine end-user requirements for benchmarking.

2. Organize a benchmarking team for design and implementation of benchmarking.

3. Understand the process and related activities. You need to make sure have comparability; otherwise you may end up comparing apples to oranges. The goal is to find relevant benchmarks for improving performance.

4. Research and gather "best in class" performance data. This may require interviews, research, analysis and other tasks. For small companies on a tight budget, outside services may have to supply the benchmark data. Larger companies will develop their own in-house benchmark data.

5. Analyze the data and determine performance gaps between your company and "best in class" benchmarks. Identify the causes for the gaps and establish future attainable performance.

6. Obtain senior management support for benchmarking. Finalize the benchmark standards and assess their impacts.

7. Apply the benchmarks and continuously update the benchmark data.

The best types of benchmarks focus on critical functions or processes in the business, such as production efficiency or customer service. A solid understanding of the function or process is critical to finding the right benchmark. You are trying to pull out the right performance data for external benchmarking. External benchmarking is considerably more difficult than internal benchmarking.

Finding financial related benchmark data is not too difficult. Financial benchmarks are widely available from service bureaus, market reports, financial reports, and published surveys. Financial benchmarking can help you determine the costs of a process or activity based on perfect cost conditions. The key to benchmarking is to make sure you have a good comparison. Once you have this out of the way, you should find the appropriate benchmark and allow the benchmark to help guide your performance. Always remember to benchmark against "best in class" and not averages. You are not interested in average performance; you want to move towards best in class.

Integrated Performance Measurement

A fully integrated approach is now considered a standard approach to performance measurement; especially with the advent of the Balanced Scorecard. An integrated approach recognizes that measurement should be process oriented and cut across functional areas. It also recognizes that a balanced set of measures, both financial and non-financial, is needed for a complete picture of what is going on.

The best types of measurements provide more than score keeping; they help you understand what changes are needed to improve the score. Good measurements usually start with the core competencies of the organization. By focusing on core competencies, you are measuring the strategic areas that give the organization a competitive foothold in the marketplace.

Typically a set of performance measurements will rely on Key Performance Indicators (KPI's). The best KPI's tend to be simple. Here is an example of KPI's at General Electric:

Performance Area	Key Performance Indicator
Profitability	Residual Income
Productivity	Output
Human Resources	Number of Promotable Employees
Market Position	Market Share

As you can see from this example, the primary drivers behind performance are very visible within the performance measurement system. Areas that are selected for measurement are critical to the business. Therefore, the best place to start in the design of an Integrated Performance Measurement System (IPMS) is by simply understanding how the organization works. Based on this understanding, strategic themes emerge to help you identify what areas of the business should be measured. The objective behind the design phase of the IPMS is to come up with a set of KPI's that are both measurable and reportable.

The design phase of the IPMS should be both top-down and bottom-up. The top view is needed to help ensure that design is based on major strategic issues confronting the organization. The bottom-up view is needed since you need to identify barriers and issues that must be resolved for implementation of the IPMS. The preliminary design of the IPMS will often consist of eight steps:

1. Executive Management buy-in and support for the IPMS.
2. Forming the Design and Implementation Team(s).
3. Developing a clear and concise set of strategies.
4. Drafting a prototype model for testing and refinement of the IPMS.
5. Defining the Critical Success Factors or Areas that need to be measured.
6. Defining the Key Performance Indicators that will serve as the measurements.
7. Finalize the Prototype Model.
8. Develop a plan for full implementation.

The biggest reason behind failure of a performance measurement system is lack of senior management support. In order to gain management support, an "ABO" approach is sometimes useful:

1. <u>Awareness</u>: Management shows an interest in the project, learns more, and becomes passively involved.
2. <u>Buy-In</u>: Management now seeks more information, they commit time and money to the project, and they openly support the idea behind performance measurement.
3. <u>Ownership</u>: Management assumes responsibility for success of the project, they recruit people to participate, and they sell others on the idea of performance measurement.

Once you have ABO from upper-level management, you can proceed to Step 2, forming a design and implementation team. Since the IPMS cuts across the entire organization, the team should have representation from areas that will be measured. For example, a beverage company has identified marketing and production as critical areas that need to be measured. The design team consists of five key people: Marketing Manager, Sales Manager, Operations Manager, Quality Control Manager, and Chief Financial Officer.

This article has touched on the very basics of trying to get a comprehensive performance measurement system started. A very important aspect with any project like performance measurement is to spend sufficient time with planning and design. One of the biggest mistakes with most projects is to move too quickly into implementation. A good IPMS should evolve through a process of planning and design. And don't forget to prototype test each and every idea within the IPMS. This will save a lot of grief down the road when it comes time to implement.

Balancing the Balanced Scorecard

Too many measurements, too much emphasis on financials, too few leading indicators, disregard for human resource capital, etc., etc., etc. All of these attributes represent fundamental reasons why so many Balanced Scorecards are "out-of-balance." One of the biggest problems to emerge with many balanced scorecards is excessive measurement. As Mark Graham Brown points out in his book Keeping Score, it can be worse to have too many measurements than to have no measurements at all. Brown recommends that the overall organization have no more than 20 measurements. Brown also suggests the following:

-Measurements should be based on the needs of stakeholder groups - shareholders, customers, employees, etc.
- Measurements should provide a mix of past, present and future.
- Measurements should flow from the top down to all levels of the organization to ensure linkage. Kaplan and Norton reiterate this point in their four-layer approach to deployment of scorecards (Organization > Operations > Shared Services > Individual).

One way of reducing the number of measurements is to combine several related measurements into one single index. Weights are assigned to individual measurements based on importance with a weighted average index serving as the metric within the Balanced Scorecard. One problem with the use of an index is the fact that individual measurements can get buried within the index. Therefore, the best approach is to have a few solid key indicators as opposed to an index that combines numerous indicators. However, if your scorecard is overloaded with measurements, indexing can help streamline the Balanced Scorecard.

Financial measurements will often dominate a Balanced Scorecard since many executives are addicted to earnings as a value-driver. One of the problems with financial measurement is that it is tends to be a lagging indicator; i.e. it looks back at past performance. Financial metrics within a balanced scorecard should cover three perspectives:

Historical - How did we do last period?
Current - How are we doing right now?
Future - How will we do next period?

For example, the number of customer contracts executed is an indication of future revenues and thus, this would be a leading indicator as opposed to revenues for the quarter (lagging indicator). Measurements should also look at things from a long-term perspective. Long-term strategic thinking should flow into the Balanced Scorecard. Examples of long-term measurements are customer service, human resource development, and product innovation.

Another challenge within the Balanced Scorecard is Detail vs. Summary. How much detail to include depends upon what is required for decision making. Balanced Scorecards should provide sufficient information so that people can act on unacceptable performance. The ability to drill down and see what is going on is important for problem solving.

Balanced Scorecards should reflect a balance between generic types of measurements and measurements that are unique to the organization. Most organizations have similar generic measurements, such as financial and customer service. However, each organization is unique and therefore, balanced scorecards should include measurements that are specific to the organization based on what drives value. Measurements should relate to critical areas for future success, such as maintaining your competitive edge. For example, if your competitive edge resides in innovative products, then you will need to have some measurements focused on product innovation.

No one metric should dominate the scorecard; after-all it needs to be balanced in many areas (operations, customers, financial, etc.). You also need to change your measurements with changes in strategy. Strategies should be changing all the time due to marketplace changes, technological changes, etc. Finally, see if you can answer yes to the following questions about your Balanced Scorecard:

1. Do our measurements reflect the critical strategies of the organization so that we will grow and remain competitive in the future?
2. Everyone within the entire organization, from employee on up to CEO, is not evaluating more than 20 measurements each period within their balanced scorecard?
3. Measurements throughout the organization flow together and no set of

measurements is floating alone, separate from the remainder of balanced scorecards in the organization?
4. We have a set of measurements that is balanced - Mix of past, present, and future; mix of unique and generic; balance within categories (operations, customer, human resources, financial, etc.); and balance between detail vs. summary.

Once a strategic map has been developed, balancing the Balanced Scorecard is perhaps the most challenging goal in building the scorecard. Indexing, time dimension, integration from top to bottom, and an emphasis on stakeholder groups can all help ensure that your balanced scorecard is balanced.

The E2K Metric

One of the most significant challenges facing finance is to provide information faster and faster to end-users. By acting on information as it is produced, decisions are more effective and the costs associated with the information declines. To help drive this mandate for finance, the Event to Knowledge Metric or E2K Metric is applied.

E2K measures the time between when an event occurs and when the knowledge can be acted upon. The objective is to reduce the E2K time so that decisions are made as close to the event as possible. For example, it may take 5 days before all allocation entries are posted to a series of accounts, providing income information by cost center. By integrating all centers into a new automated system, this time is now reduced to 3 hours. Operating managers can now act on sales targets the same day the information is produced.

One place to look in reducing E2K time is internal reporting. Most companies are preoccupied with cranking out report after report with no regard with how the information is used. Transforming information into knowledge and reducing the inordinate amount of time on reporting are two fundamentals steps to cutting down on E2K times. Another obvious way of reducing E2K is electronic distribution of information to end-users. In some cases, quick flash reports can serve as preliminary sources of information before final reports are prepared and released.

In his article titled Event-to-Knowledge[1], Frank Potter describes four basic strategies for reducing E2K time:

1. Increase the material threshold for accrual and other adjusting entries.
2. Pre-calculate your monthly adjustments ahead of time, such as monthly depreciation.
3. Post more frequently to sub-ledgers and make correcting entries before month end closings.

[1] Event to Knowledge by Frank Potter, Strategic Finance Magazine, July 2001

4. Review the allocation and distribution process; making sure it is streamlined and efficient.

For labor-intensive businesses, getting your accounting cycles in sink with your payroll cycles can yield big results. No more payroll estimates, accruals, and reversing entries. And labor costs are now reported in the financials every two weeks or weekly.

However, the biggest step towards cutting E2K times is gained through "just in time accounting." Just in time accounting provides accounting and financial information on a daily basis. At the heart of just in time accounting is the Virtual Close. Under the virtual close, the accounting records are closed by 2:00 p.m. the following day as opposed to the traditional close, which takes place once a month:

Event	Traditional Close	Virtual Close
30-day monthly period	30 days	1 day
Month end closing process	5 days	1½ day
Generate / Distribute Financials	4 days	½ day
End User acts on information	2 days	½ day
Total E2K	41 days	2 ½ days

The Virtual Close was popularized by Cisco Systems, which integrated all of its systems and technologies over an eight-year period. Web based applications are often deployed for virtual closings since they provide the infrastructure for instantaneous sharing of information. According to Cisco CFO Larry Carter, "We can literally close our books in hours. More important, the decision makers who need to achieve sales targets, manage expenses, and make daily tactical operating decisions now have real-time access to detailed operating data."[2]

According to Mark Kruger of AnswerThink, all of our clients are moving toward the virtual close, cutting between a third to one half of their closing cycles.[3] Kruger suggests many larger companies can simply cut their E2K's by consolidating all of their companies – "Every legal entity costs around $ 250,000 to $ 500,000 to maintain because people spend money to account and consolidate those transactions."[4]

Getting to the virtual close can be a monumental task because of the diversities that exist within a business. Everyone needs to get the right information to the right location on time with minimal errors. Once you have the system in place, you begin to reap the benefits. According to KPMG Consulting, the real benefits of a virtual close are not generating consolidated financials within hours or days, but giving decision makers instant access to critical information so they can be more pro-active.

[2] Cisco's Virtual Close, Harvard Business Review, April 2001
[3] A Virtual Close: as Easy as One, Two, Three? CFO Magazine, March 2001
[4] A Virtual Close: as Easy as One, Two, Three? CFO Magazine, March 2001

One final point about E2K and the Virtual Close concerns the balance for accuracy. In light of the Enron collapse, the rush to "optimize" the financial function must be balanced with the goal of producing accurate financials. Therefore, as you move towards optimization, don't forget to balance optimization with controls that ensure high levels of accuracy in financial reporting.

It's Time to Start Measuring Leadership

Over the last few years there has been enormous interest in the subject of leadership. In the last three years alone, over 5,000 books have been published on leadership. There is little doubt that leadership is a critical catalyst for driving value. However, one thing that seems to be missing is some form of measurement. If we fail to measure leadership, how can we understand if it exists and to what extent does it influence and drive performance.

The good news is that many of the characteristics of leadership are well documented, giving us a relatively easy model for measurement. Since leadership tends to be very intangible, our approach to measurement will be more casual and soft when compared to traditional measurements such as financial metrics. For example, simple feedback may suffice over hard measurements, such as a peer review survey. However, just like any measurement process, we will look for consistent trends to flag action items for improvement.

Before we embark on measuring leadership, let's make sure we understand what we want to capture. Leadership is basically the capacity of someone to bring about change. Using this definition, we need to make sure we cast a wide net with our measurement of leadership. This helps ensure that we recognize where the real leadership is at which in turn allows us to leverage it for greater organizational performance.

One of the most accepted models for measuring leadership comes from James M. Kouzes and Barry Z. Posner, authors of the book The Leadership Challenge: How to Keep Getting ExtraOrdinary Things Done in Organizations. Kouzes and Posner have devised the so-called Leadership Practices Inventory or LPI. The LPI Measurement Model uses a series of questions to assess leadership effectiveness. People under a designated leader are observers, evaluating leaders on a series of qualities, such as:

- Discusses future trends on how I can change my work
- Provides positive feedback on accomplishments
- Follows through on promises
- Treats others with respect
- Solicits feedback and opinions from others

The leader is also required to assess his or her leadership based on several behaviors, such as:

- Sets a good personal example
- Actively listens to other viewpoints
- Supports others in their decisions
- Willing to take certain risks and experiment

Collectively we can take these answers and assess leadership effectiveness. The LPI Model also establishes several best practices in leadership, such as:

- Challenge an existing process in a positive way
- Share your knowledge and power, enabling others to act
- Openly recognizing performance so as to encourage others to perform

For organizations not interested in formal models such as LPI, you might want to fall back on self awareness tests such as Meyers Briggs or evaluation forms for assessing Emotional Intelligence. Regardless of how you approach measuring leadership, the key is to have some basis for measurement. Leadership is way too important to ignore and given all the published materials available about leadership, there's no excuse for not measuring it.

Finally, don't restrict your leadership assessments to just management positions. The overall goal should be to capture and report the essence of what leadership is – the capacity to produce change. Using this broad definition, you may want to measure leadership at several organizational levels since all types of positions can qualify. By casting a wide net, you will leverage and maximize the benefits of measuring leadership.

Competitive Intelligence

The Importance of Competitive Intelligence

One of the obvious trends in business today is increased competition. One reason for so much competition is because the World is now one single marketplace. Additionally, distribution channels like the internet now make it possible for anyone to enter the global marketplace. As a result of increased competition, the rate of change taking place in business is increasing exponentially. For example, internet usage now doubles every 100 days. If you expect to keep-up and survive in this fast paced competitive environment, you must know what the competition is doing. So how do you monitor the competition in this age of information overload? The answer is with Competitive Intelligence.

Competitive Intelligence (CI) is a process whereby you collect, analyze, and transform information into intelligence so you can manage the future. Examples of CI include everything from collecting the Annual Reports of your competition to setting up automated search routines. The overall objective of CI is to identify events, trends, and other issues that will impact your organization.

The best way to implement CI is to focus on critical questions confronting your organization. For example, how will this regulation change our business or how will the introduction of a competing product impact our business? You must continually monitor critical issues if you expect to compete. If you fail to implement CI, than you run the risk of operating in a reactive mode. And nothing changes a company more than having to survive.

Collecting Competitive Intelligence the Easy Way

Don't make competitive intelligence difficult. You will be surprised at how easy it is to collect certain types of intelligence. The most reliable forms of intelligence are primary sources. Primary sources of intelligence include:

1. Speeches by executive management that provides intelligence about future strategies of the Company. This would involve all types of communication mediums: TV, Radio, Business Magazines, etc.
2. Annual Reports and SEC Filings of companies.
3. Product Spec Sheets and other company literature distributed at trade shows, conferences, and other events.
4. Physical observation of operations, facilities, and other activities. For example, if you wanted to estimate the volume of gasoline from a distribution point, you can count tanker trucks over a representative sample period.

Secondary sources of intelligence are easier to collect, but are not as reliable as primary since they come from secondary sources. Secondary sources of intelligence include:

1. Articles, news stories, and other features created by someone outside the company about the Company.
2. Books about the industry and/or companies in the industry.
3. Special studies, research papers, and analyst reports about an industry and/or company.

Although secondary sources are not always as reliable as primary sources, they can provide a much broader view of industry trends and strategies. Finally, don't forget to do an intelligence audit within your company. You will be surprised at the many sources of intelligence residing within your company. Journals, publications, and employees are potential sources of intelligence.

Collecting intelligence is like an Easter egg hunt. Eggs are hidden everywhere. Your challenge is to go out and collect the intelligence wherever you can find it. And once you collect it, analyze it and translate it into strategies for managing the future.

Competitive Intelligence: An International Perspective

Unlike the United States, many countries place a much higher value on competitive intelligence. For example, the Japanese look at competitive intelligence as a basic competency within the organization. Nissan Motors has a library consisting of over 100,000 books, accessible to all employees. The Japanese culture lends itself to competitive intelligence. Reading and studying information from all over the World is a common activity for many Japanese. Public sources of information fuel the Japanese thirst for information and knowledge.

The Chinese are similar to the Japanese. The Chinese are very curious about the outside world. As you might expect, the Chinese Government sponsors several competitive intelligence programs. The real problem for the Chinese is a lack of infrastructure to support competitive intelligence.

France is perhaps one of the best countries for competitive intelligence. The French are very aggressive in learning what the competition is doing. The French Government works hand-in-hand with French companies to collect and gather intelligence. Since the French take competitive intelligence so seriously, it has become a major strategic advantage for the French in the global marketplace.

England is similar to the United States. Competitive intelligence is not taken seriously. Most large businesses have not developed competitive intelligence as a core competency within the organization. However, this is starting to change as more executives recognize the importance that competitive intelligence plays in strategic planning.

Organizing the Competitive Intelligence Effort

The development of strategies to compete is essential for the future survival of every organization. Competition is increasing from everywhere. Understanding this external, global environment is now part of how you must strategize. Competitive Intelligence (CI) is the process by which you collect and analyze information to better understand the external environment. The product of Competitive Intelligence is knowledge that facilitates decision making, both strategic and operational. Therefore, CI is both a process and a product.

Finding sources for competitive intelligence is not a problem. However, sources can vary widely. Some examples include press releases from the competition, trade journals, customers, suppliers, employees, banks, investors, government reports, market surveys, etc. The challenge is organizing and making competitive intelligence a core competency within the organization.

One good place to start is to do a competitive intelligence audit; i.e. take an inventory of what you already have. Pull together all of the pockets of information scattered throughout your organization. Over half of all competitive intelligence information is accessible through your own organization. Once you have competed the CI Audit, define your competitive intelligence objectives and outline a plan that will make competitive intelligence a major decision support service within the organization.

Some critical questions that should be asked are the following:
- How much information do we already have?
- What additional information do we need?
- How will we use this information?
- How will we transform this data into intelligence? What formats will we use?
- How much time and effort is required for CI?

Also try to place emphasis on the following:
- Design competitive intelligence so that it anticipates future events, such as changes to the competition through mergers.
- Competitive intelligence should tell you what areas to avoid as well as possible opportunities.
- Competitive intelligence will fill gaps or areas that otherwise would go unnoticed by the organization.
- Make sure competitive intelligence is a continuous process since the competitive landscape is always changing.

One of the main outputs of competitive intelligence is identification of the competition. A customer driven approach is a good starting place for identifying your competition. Identify those companies that compete against your company at the product or service level. What other companies offer similar products and services? Once you have identified the competing companies, you need to isolate the differences between your company and the competition. Since an analysis of differences can be difficult, focus your attention on strategic differences. For example, many of these differences will relate to competitive advantages and disadvantages. What areas are we better and worse at in relation to our competition? Try to pick up on trends and patterns that are going forward. For example, what are the relationships between your company and the competition regarding price, cost, distribution, quality, innovative products, etc. If price represents a basis for competition, then your CI effort needs to identify the cost structure going forward. If quality is important to competing, then CI will need to obtain information about customer satisfaction. Keep in mind that your competition is seeking to match or exceed your competitive advantages. Therefore, protecting your competitive advantages is one of the key benefits behind competitive intelligence.

Organizing a competitive intelligence effort is paramount to protecting your values within the marketplace. Competitive intelligence will allow you to manage and react very quickly to changes in the external environment. Competitive intelligence will not only help you identify and monitor the competition, but you can expand competitive intelligence to monitor issues that profoundly impact your organization (such as deregulation, technology, social changes, etc.). Finally, the process of competitive intelligence will require substantial support from senior management since it must become an integral function within the organization. Without some form of competitive intelligence in place, strategic decision-making will run the risk of being too inward thinking. In today's global, competitive marketplace, you must give consideration to the external environment. Competitive intelligence will make you see things externally.

Leveraging Competitive Intelligence

This article will discuss some specific tactics that should be considered for leveraging an existing competitive intelligence function. One of the major challenges you will face is how to balance competitive intelligence within the organization.

For example, a highly centralized competitive intelligence function will facilitate focus and strong strategic decision-making. On the other hand, a very decentralized competitive intelligence function will promote better operational decision-making. In any event, there is a need to establish some structure for competitive intelligence to work.

Competitive intelligence is often structured around the ability to analyze and transform data into intelligence. In order for this process to work, you need to place competitive data into a structure that accounts for relevant relationships. Competitive intelligence is the process of taking small chunks of information and building a "big picture" scenario for directing strategic and operating decisions. This requires focus on critical areas, such as customer research, monitoring the strategies of the competition, benchmarking performance against the competition, etc.

Competitive intelligence is also leveraged by making sure you understand the competition. One way to better understand the competition is to categorize the competition based on some unique attribute. This will make it much easier for everyone to clearly understand how the competition functions. For example, one competing company may be growth oriented while another competing company is financially oriented in its thinking. Another way to categorize the competition is to identify their core competencies. Most companies are very aggressive about defending their core competencies. Other companies may need to be categorized based on vertical integration.

Another way to better understand the competition is to understand what measurements they use. This will give you insights into how adept the company is at managing value-creation. Try to determine what value drivers are most important to your competition. The objective is to distinguish the competition by some attribute that allows everyone to understand what makes the competition tick.

Competitive intelligence not only identifies the competition, but it also looks into emerging competition that enters the marketplace given a change in regulations, technology, etc. For example, deregulation can trigger a new wave of competition. All of sudden your competitive advantages are under extreme assault. Competitive intelligence needs to go beyond an understanding of the competition. It needs to help you understand the external environment that you are operating in.

Competitive intelligence is often viewed as a tool for maintaining marketplace share. However, competitive intelligence should be leveraged by directing the organization out of the marketplace; providing guidance on an appropriate exit strategy. As barriers to competition erode away, more and more companies will enter the marketplace. Your organization should not restrict competitive intelligence to maintaining market share. You may reach a point where you need to consider an exit strategy as values decline. Competitive intelligence will ascertain some of the problems associated with staying in the competitive marketplace. For example, a strategy to compete based on price may not work in the long run.

Another challenge facing competitive intelligence is how to balance timely information with reliability. Unfortunately, each and every source varies in relation to timeliness and reliability. Here are some examples:

- Secondary Research (fast, easy, reasonably reliable)
- Interviews with Industry Experts (fast, not very reliable)
- Market Surveys (time consuming, very reliable)
- Focus Groups (in-depth, somewhat unreliable)
- Employees (good source, but not very reliable)
- Customers (excellent source, but requires careful thought)

A final point on leveraging competitive intelligence concerns building a competitive intelligence database or more specifically, a data warehouse. The Data Warehouse will allow you to leverage all of the data residing in your operating systems. The objective is to consolidate the relevant data into one system for better decision-making. Several gaps will need to be filled in order to make competitive intelligence complete. And don't forget to measure the impact of competitive intelligence on your organization. Evaluating the competitive intelligence effort will help ensure that it is a value-added type of activity.

Process Improvement

Improve Accounts Payable Processing with P-Cards

One of the newest ways to re-engineer Accounts Payables is through the use of procurement credit cards or P-Cards (Purchase Cards). Accounts Payable is often a very non-value added type of activity. It involves a lot of time and expense with marginal benefits. For example, accounts payable may involve processing purchase orders, preparing checks, stuffing and mailing-out payments, posting entries from all kinds of source documents, etc. Suppose you could reduce this activity by simply using procurement credit cards to consolidate much of the process. That's what P-Cards are all about!

Here's how they work. Instead of purchasing with requisitions, purchase orders, invoices, and checks, you now streamline this entire process by issuing purchase cards to certain people in your organization. Processing costs are reduced and you receive special reports that itemize your purchases on one single statement. Purchase Card Programs require a "buy-in" by all participants: Management must OK the P-Card Program, employees must accept using them, vendors must honor them, and the bank has to offer a quality P-Card Program. If you can get all four of these lined-up, then it's well worth investigating.

Make sure you look at your current payables workload before selling the idea of a P-Card Program. For example, how many invoices will you eliminate with P-Cards? If P-Cards will cover only about 1% of your spending, then it probably isn't worth implementing. However, most researchers have indicated that the typical payable function has 80% of its purchase transactions accounting for less than 20% of total purchase dollars. Therefore, considerable time and effort can be saved through a P-Card Program.

You can also setup unique controls within a P-Card Program. For example, purchase credit cards can be programmed for purchase limits by transaction, by day, by month, etc. Special reports can be used to reconcile purchase transactions directly with general ledger accounts. The reconciliation process can be streamlined by having users submit on-line monthly reconciliation's to the Payables Department.

The bad news is that most banks still don't offer P-Card Programs. Three banks that do are: Bank of America (1-800-305-7735), PNC Bank (1-888-762-6011), and Norwest Bank (1-800-524-8189). If you are seeking to streamline your accounting functions, you owe it to yourself to take a serious look at purchase credit cards for consolidation of payable transactions.

Reaching for the Six Sigma

One of the hottest approaches to process improvement in the last few years has been Six Sigma. Six Sigma has been embraced as a statistical methodology for increasing quality, lowering production costs, and improving profitability. In the words of Jack Welch, CEO of General Electric: "Six Sigma GE Quality 2000 will be the biggest, the most personally rewarding and, in the end, the most profitable undertaking in our history." According to Richard Wallman, CFO for Allied Signal, we will save $ 175 million in our first year of Six Sigma and this number will double in the second year.

Six Sigma was started by Motorola as a way of reducing defects in the manufacturing process. Six Sigma represents a statistical measurement of variation from a specific attribute or characteristic desired by the end-user. Six Sigma is expressed over six exponential layers:
One Sigma = 690,000 defects per million
Two Sigma = 308,000 defects per million
Three Sigma = 66,800 defects per million
Four Sigma = 6,210 defects per million (relatively efficient)
Five Sigma = 230 defects per million (world class efficiency)
Six Sigma = 3.4 defects per million (perfection)

Six Sigma provides a universal measurement standard for all processes throughout the organization. Sigma layers give an indication of how much failure is occurring within a process. It is estimated that a company operating between the third and fourth sigma can expect about a 10% loss in revenues from inefficiency. Moving from one sigma to the next is a major undertaking. A 30-fold improvement in quality is required to get from Four Sigma to Five Sigma.

Six Sigma is a very rigorous approach to improving quality within your products and services. Processes that are critical to products and services must be analyzed in detail. Techniques like process mapping and pareto charts are often used to understand the details within a process. Generally, Six Sigma will follow a four phase approach:

1. Measure - Determine the error or defect rate
2. Analyze - Understand the Process
3. Improve - Reach for a higher Sigma
4. Control - Monitor through measurement

Few companies have made it to the Six Sigma (3.4 errors per one million). However, where defect rates are extremely costly, reaching for the Sixth Sigma is now a given expectation. It is worth noting that Six Sigma requires formal training in the statistical methods that are used. Leaders of Six Sigma are called "black belts" while participants in Six Sigma are called "green belts." Once trained, the trick is to move the black belts around to critical areas for improvement.

One reason Six Sigma has become so popular is because companies want to eliminate non-value added activities as quickly as possible. Other approaches to process improvement, such as Activity Based Management, can take considerable time with marginal improvements. According to Mikel Harry, author and founder of Six Sigma, the defects and errors within a process are a key indicator of non-value added activities. For example, when a coding error occurs in payables processing, you have to put procedures in place for detecting the error, tracking the error, and correcting the error. All of this takes time and resources. When you eliminate the errors, you immediately reduce or eliminate the non-value added activities.

It is quite clear that many large corporations have made Six Sigma an integral part of their strategies. Operating people have long accepted Six Sigma as a way of improving quality. The challenge now is for financial management to adopt Six Sigma as a way of creating higher values and increased profitability.

A final word of caution - don't forget to look at the cost/benefit of reaching for the Six Sigma. An extremely low defect rate at a $ 5 billion Motorola facility is not the same as a low defect rate at a $ 1 million shoe manufacturing facility. The costs of going to a higher sigma may not be beneficial. As a result, some in financial management are using Activity Based Management as their guide to the deployment of Six Sigma.

Value through the Supply Chain

Maintaining a competitive advantage is a balance between providing great value for customers and doing it in such a way that your costs remain competitive. If you cut costs too much, you destroy your ability to service the customer. And service is the key ingredient behind customer retention. If your costs are too high, then your competition may gain an advantage in properly balancing costs with customer value. It should be noted that the value-chain encompasses all activities from design of products and services all the way through to the support of customers after they buy the product.

The buzzword for this whole process is called Supply Chain Management (SCM). The objective of SCM is to have all links in the chain working together, delivering products and services to customers when, where, and how they want it. At the same time, SCM must focus on minimizing costs and resources so that value is enhanced. Most value chains will consist of three links:
Distribution: Delivering products and services to customers.
Production: Converting resources into finished products and services according to the demands of the customer.
Resources: Acquiring the materials, people, and other resources to produce the required product or service.

Since this entire process is customer driven and since Distribution is closest to the customer, we start by looking at the Distribution link. Traditionally, distribution had several links, manufacturer to agent, agent to distributor, distributor to retailer, and retailer to customer. In today's global e-commerce world, it is quite common to see only two visible links: Manufacturer selling directly to the customer. By removing links, we cut down on lead times and reduce costs within the supply chain.

One useful tool for streamlining distribution links is the customer product map. A customer product grid or map will differentiate customers. For example, some customers prefer to buy direct while others prefer traditional distribution outlets. Customer maps also identify product mixes, geographic markets, seasonal patterns, and other relationships important to customer demand. Collecting information about customer demand is extremely important. The objective is to get the customer involved in driving Supply Chain Management (SCM).

Once distribution has been re-designed around the customer, the next step is to integrate production into distribution. You need a production process that is fast, flexible, and centered around the customer order. Gone are the days of producing standard products within standard cost accounting systems. The process is now customer driven with throughput accounting, no longer relying on production forecasts.

After production and distribution have been engineered to fit the marketplace, you can move to the Resource Area with SCM. Resources must be managed on a Just In Time basis, delivering materials and other resources only as they are needed. This will require that you educate suppliers as to your marketplace needs. Establishing strong relationships with everyone involved is critical. In some cases, you may need to phase-out certain suppliers in favor of the more networked, leading-edge suppliers you can fit with e-procurement applications. Additionally, it may be necessary to share costs with suppliers in order to retain relationships.

A good example of reinventing the supply-chain is IKEA, a retail furniture store. The first part in the value-chain is product design: IKEA uses simple designs and parts. Secondly, IKEA keeps costs down by having the customer transport the product to the home and assembly the product. This eliminates non-value added links in the value-chain. Third, IKEA sells products of extremely high quality. IKEA also leverages technology and its Scandinavian image to create a competitive advantage through inventory management and marketing. The leveraging of core competencies is critical to squeezing value out of the supply-chain.

The entire supply-chain should be evaluated, from suppliers to end-users of the product. Supply-chains must be externally focused in a highly competitive environment. This requires that you work very closely with suppliers, customers, and everyone involved in the supply-chain. Finally, costs are controlled by looking at what drives the costs. The objective is to manage your activities better than the competition. Letting the customer guide the process (SCM) is how you can meet this objective.

Focusing on the Process – Part 1 of 2

All businesses require processes for the creation of products and services. A process is a collection of activities that consumes resources and adds value to the consumer (in the form of products / services) with some form of benefit paid to the producer. Additionally, all processes have variation – in business we call this risk. As H. Edward Deming, pioneer in the field of quality management, points out – If you can better understand variation in a process, then you can plan for it and do things to prevent it.

Unfortunately, there is a viewpoint that people may represent the source of problems for most business processes. A much better approach is to understand how people and their activities fit within the process. Processes tend to superimpose control over people and in today's entrepreneurial world, no-one wants to be controlled. Therefore, by focusing on the process, as opposed to looking at people as the source of the problem, we unleash the human capabilities of the organization. Too often, management is working to change people when it should focus more on changing the process which in turn leads to positive change on people. Additionally, when you focus on the process, you switch over from short-term bottom line thinking to quality, customer driven thinking. This is a much more sustainable approach to real long-term growth and profitability.

By focusing on the process, you will:

- Better focus on the customer
- Improve competitive position through quality and service
- Gain insight into how errors are introduced into the business leading to preventative measures for improvement and elimination of error correction activities (such as Six Sigma)

Managing a process begins with a very detail understanding of how the process works. This may require organizing the company for process improvement – appointing team leaders, investing in training, and running pilot programs on critical processes. One simple way to understand a process is to flow the process using a block diagram. Block diagrams provide simple visual flows of what takes place within the process. Once you understand how a process works, the next step is to make it efficient. This usually requires an emphasis on reducing errors and defects that occur within the process. Additionally, removing barriers within a process is a common way of empowering people and improving the process.

"We are spending all of our time saying: 'I'm sorry, I'll fix it', to customers who are increasingly sophisticated and understandably impatient. What we should be doing is developing processes that will make it unnecessary to ever apologize for inadequacies."

- Business Process Improvement: The Breakthrough Strategy for Total Quality, Productivity, and Competitiveness by H. James Harrington

Another common attribute of process management is measurement of the process. Common measurements for a process include resource consumptions per unit, cycle times, wait times, and % value added per unit. Reducing time related measurement's is often a goal behind process improvement. This may require additional automation and upgrading of technologies.

Many managers seem to equate process improvement projects in relation to costs. Unfortunately, many managers never evaluate a process in relation to quality, they always jump to the question: How much is it going to cost? Therefore, managers need to understand the relationship between quality and costs. Quality and costs go hand in hand for process management. By improving quality, costs naturally come down.

"With better quality and lower costs, you can capture the market." – H. Edward Deming, leading advocate of quality management

Finally, instead of forcing people to fit with the process, try changing the process to fit with the needs of stakeholders involved in the process. This usually requires "reengineering" the process. Part 2 of this article will outline the foundation behind process reengineering and the importance of involving all stakeholders within the process.

Focusing on the Process – Part 2 of 2

The words "business process reengineering" still leaves a negative impression to many of us in the business world. Years ago companies rushed to reengineer their processes to improve quality and efficiency. However, the end result was less than desirable – new processes were layered on top of existing processes resulting in more work with fewer people. Costs were temporarily lowered benefiting investors. However, other stakeholders in the process, such as employees, were victimized by reengineering.

Real reengineering is more about including everyone involved, so that there are no losers and winners from reengineering. The words collaboration, connecting all players, more transparency, and more openness are now part of the reengineering vocabulary. The buzzword for this new or real approach to reengineering is X Engineering. The "x" refers to crossing; i.e. reengineering must cut across all organizational boundaries. Author and consultant James Champy pioneered this more human approach to reengineering in his book: X Engineering the Corporation. Author and e-commerce expert Thomas Koulopoulos refers to this as the x-factor, creating communities whereby people can collaborate.

"X engineering is about optimizing relationships so that companies can tap the full sum of the intelligence and experience of all of the people in its network of customers, suppliers, and partners. To accomplish this goal, the processes in which

these people participate must be arranged to work smoothly both within an organization and between the organization and its customers, suppliers, and partners."
- X Engineering the Corporation by James Champy

Processes are no longer tightly controlled and restricted from view. Processes are now easily accessed over the internet. If a process is performed in isolation from others, then management must determine if the process is really isolated. How do we open it up to outsiders so that we can improve it and lower its costs? Are we leveraging technology to transform this process?

One obvious obstacle to x-engineering is resistance. Many partners may not want open-up and change; they will refuse to share information. The challenge for management is to break through this deadlock by deploying a single, standard process that allows everyone to work together seamlessly. One reason this is so important is because customers are increasingly sophisticated and demanding. In order to properly serve the customer, everything within the supply chain must be connected and coordinated. Everyone takes ownership, assuming specific responsibilities for making sure their part of the process is managed flawlessly. Supply Chain Management (SCM) now evolves into Supply Chain Relationships (SCR). And we can compliment these processes with Customer Relations Management (CRM) and Employee Relations Management (ERM).

The reasons behind reengineering remain the same – increased competition, the need to improve customer service, the need to lower costs, and the need to keep up with technology. However, the significance of these drivers is becoming more demanding. As a consequence, many companies are becoming exhausted, run-down and giving up on these incredible demands to reengineer the business. However, instead of admitting defeat, management should view these challenges as new opportunities. And by connecting all players through technology, real reengineering (or x-engineering) can become a real value-adding proposition. It will require a new mindset whereby management is openly sharing their processes with others in a way that allows reengineering to take place for the benefit of everyone. And with technologies like the internet, there is no excuse for not making it happen.

Avoiding Six Sigma Sickness

It seems everything within corporate America is getting six sigmitized. Yes, Six Sigma is a well-defined methodology for improving quality, which in turn, leads to control over costs. However, like any major business initiative, Six Sigma can have its drawbacks. This article will outline a few of the pitfalls that sometimes are associated with Six Sigma.

Before we jump in – let's go back to what Six Sigma is. Six Sigma is about how you use resources and the more resources consumed, the higher your costs. Therefore, if we require less time, effort, materials, and other resources to produce something, then we invariably lower our costs. Activity Based Costing also tried to deliver on this cost control approach; but Six Sigma finally broke through on giving management a set of standard tools for controlling costs within a process. One of the big payoffs for Six Sigma over other re-engineering programs is that more effort is not required (at least that's what the experts say). Unlike other process improvement programs where people are forced to work harder, Six Sigma is aimed at getting people to work smarter, not harder.

"It would be a mistake to think that Six Sigma is about quality in the traditional sense. Quality, defined traditionally as conformance to internal requirements, has little to do with Six Sigma. Six Sigma is about helping the organization make more money by improving customer value and efficiency. Six Sigma focuses on customer requirements, defect prevention, cycle time reduction, and cost savings. Thus, the benefits from Six Sigma go straight to the bottom line. Unlike mindless cost-cutting programs which also reduce value and quality, Six Sigma identifies and eliminates costs which provide no value to customers, waste cost."
The Six Sigma Handbook by Thomas Pyzdek

Where Six Sigma does excel is in the setting of standards for measuring, analyzing, and reducing inefficiency. However, forcing every single business activity into this Six Sigma Model may not work. Such was the case with NBC, a business unit of General Electric. Not every activity or process should be squeezed into a quantifiable model when in fact, the real value proposition gets completely lost. For example, a book publisher followed the Six Sigma Model in the production process of books. The production process became perfect – every letter on every page was produced without defects and no books were rejected from the assembly line. However, no-one was interested in buying the books – the content itself was poorly developed. The real value that the product creates for the customer got lost in the Six Sigma frenzy of perfection within the production process.

Another common problem with Six Sigma is playing games with the numbers. How you categorize and define defects is significant in how well you meet Six Sigma targets. For example, do you look at the number of defects throughout the motherboard of a personal computer or do you look at defects on the PC Battery installed on the motherboard. By simply changing the definition, you can dramatically change your sigma level of perfection.

Like so many major initiatives, Six Sigma can receive less than enthusiastic response from workers. For example, Six Sigma can be somewhat divisive – a few people are chosen as Black Belts, a larger group is selected as Green Belts, and others are not included at all. In order for Six Sigma to be truly accepted, everyone should be given an opportunity to become a Green Belt and people who have demonstrated strong leadership on improvement issues should be considered for Black Belts. Don't exclude people on such a major enterprise-wide initiative as Six Sigma.

Start with selected processes; don't go full scale until you work out the bugs. From initial projects, you can roll-up “lessons learned” into further projects. Up to one-third of your process should be considered for Six Sigma at the outset since many will fail to fit with the Six Sigma methodology. You want to flush out the successful practices that will work since you need to leverage your investment in Six Sigma. And the investment can be high (especially for black belt training). Additionally, it’s best to run pilot programs to work through design flows and techniques.

Finally, Six Sigma should not be viewed as TQM (Total Quality Management) or a new approach to re-engineering. People are very skeptical over such initiatives. Instead, you should allow people to use Six Sigma as a set of management tools for changing how they do things. And when balanced against other value-added management processes, Six Sigma should compliment and add value in its own unique way without impeding other critical drivers of success. If you fail to find this right balance, Six Sigma can be a recipe for making you sick.

A good example of how Six Sigma can make you sick was Polaroid. Polaroid, a large manufacturer of cameras found out the hard way. Polaroid put enormous emphasis on quality, but failed to pay attention to a critical product substitute, digital cameras. As a result, Polaroid went bankrupt despite its outstanding quality. So make sure you balance Six Sigma against all those other factors in running your business; otherwise you will destroy value in the name of quality. This is perhaps the biggest risk with Six Sigma – getting blindsided by all those other things that impact your business.

Keep in mind that “quality” is almost a given in the marketplace; i.e. when you and I buy an automobile, we expect high quality. The point is simple – quality may not be as important to your long-term survival as other factors. And if your focus is narrow and driven by Six Sigma alone, then you will invariably get sick, just like Polaroid.

“Implementation of any change effort within an organization is difficult. However, compounding the difficulty with Six Sigma is the level of associated comprehensive tools and techniques. Resistance is a natural, often genetic reaction to any change in our lives. Unmanaged and unaddressed, the resistance to Six Sigma will spell the downfall of the effort.”
- Making Six Sigma Last by George Eckes

Human Resource Management

Metrics for Human Resource Management

Human Resource Metrics has become important for Balanced Scorecards and other performance measurement systems. The reason is due to the need for effective management over human resource capital; i.e. the intellectual capital that drives value. And to make matters more urgent, senior management often fails to comprehend the value of human resources within the organization. It is quite common to see little emphasis on human resource management within a balanced scorecard. Consequently, it has become very important to demonstrate the value of human resource capital to executive management. In one simple application, one CFO decided to apply the P/E (Price to Earnings) Ratio to each new employee. If the employee costs the company $ 50,000 per year and the P/E Ratio is 5, then the employee should generate $ 250,000 in value. However, a much better approach to human resource (HR) metrics is to delegate the design to HR people; i.e. let the HR people demonstrate the value of human capital to the Non-HR people and not vice versa.

The first step is for HR people to make the transition from "liking people" to "liking value." The sad fact is that many HR people simply don't understand or grasp concepts within value-based management (such as EVA, economic profits, etc.). Once HR people understand value-based and financial metrics, then you can move into developing a set of metrics that recognizes the relationship between human resources and finance. The primary focus is on people and how are we going to develop our human capital.

A good place to start is with a set of efficiency ratios to see how well you are managing human capital. The Society of Human Resource Management has identified ten key human capital measurements:

1. Revenue Factor = Revenue / Total Full Time Employees
2. Voluntary Separation Rate = Voluntary Separations / Headcount
3. Human Capital Value Added = (Revenue - Operating Expense - Compensation & Benefit Cost) / Total Full Time Employees
4. Human Capital Return on Investment = (Revenue - Operating Expenses - Compensation & Benefit Cost) / Compensation & Benefit Cost
5. Total Compensation Revenue Ratio = Compensation & Benefit Cost / Revenue
6. Labor Cost Revenue Ratio = (Compensation & Benefit Cost + Other Personnel Cost) / Revenue
7. Training Investment Factor = Total Training Cost / Headcount

8. Cost per Hire = (Advertising + Agency Fees + Recruiter's Salary/Benefits + Relocation + Other Expenses) / Operating Expenses
9. Health Care Costs per Employee = Total Health Care Costs / Total Employees
10. Turnover Costs = Termination Costs + Hiring Costs + Training Costs + Other Costs

It is also important to benchmark your HR metrics against past performance and other companies. For example, if you report turnover costs of $ 50,000, the CEO may think this is too high, but when you benchmark it, you are in the top 20% for lowest turnover costs. One of the best sources for HR benchmarks is the Saratoga Institute in Santa Clara, California.

HR Metrics, like other measurements within the Balanced Scorecard, should have strong connections to the strategies of the company. This will help ensure that the evaluation of HR really matters to the organization and we are working to make things happen. Listed below are some critical questions that GTE used in their award winning HR Balanced Scorecard:

Strategic Perspective

- Do we have the talent we need to be successful in the future?
- Are we investing in growing our HR capabilities?

Customer Perspective

- Are we viewed as a great place to work?
- Are we creating an environment that engages our people?

Operational Perspective

- Are our HR management processes and transactions efficient and effective?
- Are we using technology to improve HR efficiency?

Financial Perspective

- Is our return on investment in people competitive?
- Are we managing our cost of turnover?

A final point that needs to be emphasized is the correlation between human capital and the creation of value. Watson Wyatt, a major consulting firm, recently released the results of a one-year study on human resource management practices for 405 publicly traded companies. The study concluded that there is a correlation between how human resources are managed and the amount of shareholder value. According to Bruce Phau, head of Watson Wyatt's measurement division, if you can improve your human resource management in certain key areas, you can experience a 30% increase in shareholder value. The message is clear - measuring and managing human capital is a major part of creating value and it must be a key component of the Balanced Scorecard.

Cross Functional Teams

Financial management, like most disciplines is becoming driven by projects as opposed to routine day-to-day work. Projects help facilitate needed change and represent the real value-creation activities of the organization. At the heart of projects is the Cross Functional Team (CFT). The CFT is a small group of people, committed to reaching project goals, which in turn brings about improvement within the organization. Understanding what makes a good CFT is important to successful project management and ultimately to the creation of value.

What makes a good CFT? Here are some key elements:

- Everyone within the CFT must be dedicated to improving the company's performance.
- CFT's should measure their own performance and set deadlines for getting things done.
- CFT's should have the ability to move around the organization and cross through organizational hierarchies.
- CFT's should have strong support and resources from senior management, including training, staffing, funding, autonomy, and time.

Choosing the right projects and the right people for the CFT is extremely important. The closer the "fit" a project has with the use of CFT's, the more likely the project will be successful. Projects that lend themselves to CFT's include:

1. Project requires the involvement of several departments.
2. Project impacts or influences outside customers or end-users.
3. Project deals with a major strategic issue.
4. Project requires considerable time and resources.
5. Project deals with a complex area where errors and mistakes are common.

As a general rule, CFT's should be considered when you have a project that:

- Represents a major challenge
- There is a sense of urgency
- Project has major implications within the organization.
- Project has high risk and mistakes are likely to occur.

When choosing members for the CFT, three important factors to consider are:

1. Technical Expertise - Education, knowledge, experience, etc.
2. Problem Solving Abilities - The ability to identify problems and develop solutions.
3. Interpersonal Skills - The ability to communicate, temperament, personal skills, etc.

If possible, it is best to let team members join on a voluntary basis. Additionally, allow team members to choose their own assignments and name the project. This can help ensure high productivity. And don't forget to include diversity and balance within the CFT. You need to cover a broad range of skills and talents within the CFT.

The scope and size of the project will determine the size of the CFT. In cases where the project is highly complex, the CFT may form sub-teams or task forces consisting of five to eight members. If the CFT is too large, interaction and consensus is difficult. If the CFT is too small, there is a lack of creativity with a very narrow focus.

Several roles are required for making CFT's work. These roles include:

1. Sponsor or Champion: A person should serve as a bridge between senior management and the CFT so as to obtain and maintain upper-level support. Sponsors or champions are not full-time members of the CFT, they act as a liason for getting the resources the CFT needs.
2. Team Leader: The overall manager of the CFT is the Team Leader. Team Leaders coordinate activities, encourage participation, maintain cohesiveness, and direct the CFT.
3. Team Facilitator(s): Team Facilitators act like coaches within the CFT, helping prepare for CFT activities, meetings, and keeping everyone focused on project objectives. Team Facilitators have good communication and teaching skills.
4. Team Secretary: Someone will need to summarize the decisions and actions of the CFT. The Secretary keeps minutes of meetings and distributes minutes to all team members. This helps reinforce what needs to be done.
5. Team Members: Members must carryout the activities and task as indicated by the Team Leader. Team members should take their assignments seriously. Team members tend to be high achievers and they should be expected to serve for the entire life of the project.

CFT's have a much better chance of success when the goals of the project are clear and concise. The expected outcomes of the project should be specific and measurable; such as a 15% improvement in production output. Make sure upper-level management communicates the following to the CFT:

- What are the deliverables from this project?
- Why was this project chosen?
- What type of support will upper-level management provide?
- What restrictions, limitations or other special issues will affect the project?

A final point concerns how the CFT works through the project. In his book, Project 50, Tom Peters points out that the biggest mistake within a project is to move too quickly to implementation. Failure to plan and design the project will result in failed implementation. So once you have the right CFT in place, make sure you spend time planning, testing, and designing the project.

What is Matrix Management?

As Tom Peters has pointed out, the essence of most organizations is centered around projects. The traditional organization, organized around departments, is fast giving way to work by project. As project work replaces department work, more and more organizations are adopting a matrix formation to their structures.

Matrix management is the interface of an organization both vertically and horizontally. Traditional organizations consist of horizontal layers with a distinct line of command. Under matrix management, people may report to more than one person. Therefore, you could have a Salesmen report to the Finance Manager or a Production Supervisor report to the Chief Technology Officer. The balancing of horizontal and vertical structures creates a matrix or grid whereby people move according to project. Thus, the organizational chart looks like a series of vertical department columns crossed over by a series of horizontal project rows. By moving people around according to projects, skills are improved and human resource capital is enhanced. Matrix management can provide several benefits:

- ✓ Reduces the number of organizational layers down to project by project.
- ✓ Better utilizes the human resources of the organization.
- ✓ Eliminates unnecessary work and improves value-added type activities.
- ✓ Emphasizes the need to change and work around projects as opposed to department.

Matrix management does have some drawbacks:

- o It can create much more conflict since people are forced to interact with others outside their traditional areas.
- o Traditional career paths no longer exist.
- o Top managers (especially Project Managers) can gain increased power over traditional department managers.

One of the biggest challenges to matrix management is getting "buy-in" from those affected. If employees have difficulty getting along and they are suspicious of management, then employees will view matrix management as another popular fad of the month. Additionally, matrix management emphasizes core competencies and as a result, in-house personnel may find themselves outsourced. Thus, matrix management is appropriate for organizations that have wide fluctuations in their workloads. Companies involved in major project work, such as Research & Development, function well under matrix management.

Additionally, matrix management works best when an organization has clearly defined goals and there is strong fit between organizational goals and the goals of horizontal components and vertical components within the matrix. This binds the grid together and facilitates accountability through measurement (such as a Balanced Scorecard).

The evidence is quite clear. More and more companies are emphasizing projects. More and more jobs are requiring project management skills. The demand for Project Managers has never been stronger. And to solidify this trend, matrix management is becoming a standard for rebuilding organizational structures.

Measuring Returns on Human Resource Capital

One of the most under measured parts of a business is the human resource capital and it represents one of the biggest challenges facing business; namely finding the best and brightest people. It is these human resources or people who ultimately create value for the organization. People generate value through their application of skills, talents, and abilities. The key is to invest in people so that human resources are productive, knowledgeable, effective, and efficient. This is what separates the average company from the exceptional. Getting a return on this investment or ROI is extremely important.

People who create lots of value often have certain characteristics:

- They openly share their knowledge and expertise with others
- They transform data into intelligence for better decision-making.
- They pay attention to details, collecting and gathering information to reach informed conclusions.
- They communicate clearly and concisely.

We can extend this concept to all aspects of intellectual capital; i.e. people interact with processes, knowledge, systems, customers and other intangibles within the business. Once you understand this interaction, you can measure these relationships to ascertain returns on human resource capital. A critical question to ask is: What impact does a person have on these intangibles? For example, one employee may interact with complaining customers in order to gain knowledge and improve the business. Another employee may view complaining customers as a nuisance to be avoided.

Each process can have its own unique set of metrics. These metrics can be applied within a formal measurement system designed specifically for human resource capital. In his book The ROI of Human Capital, Dr. Jac Fitz-enz describes how all performance measurement systems can be placed into a matrix. The following matrix was developed for measuring Human Resource Capital (HRC):

	Acquire HRC	Maintain HRC	Develop HRC	Retain HRC
Cost =>				
Time =>				
Quantity =>				
Error =>				
Reaction =>				

In the above matrix, we would have costs associated with acquiring personnel; such as advertising, agency fees, and relocation costs. These costs would fall under Acquire HRC. The next level down is time; i.e. how long did it take us to recruit a new employee. Quantity would be the number of applications processed; often viewed as the "driver" within the process. Error refers to any event that does not meet our expectations; such as incorrect processing of new applications. Finally, the Reaction level looks at how people respond to various events within the process. This can be somewhat subjective. In any event, we can transform our matrix into a Balanced Scorecard:

<u>Perspective => Metrics</u>
Acquisition => Cost per Hire, Time Required to Fill Position
Maintain => Average Pay per Employee, Labor Cost % to Operating Cost
Retention => Cost of Turnover, Retention Rate, % of Voluntary Separations
Development =>Training Hours per Employee, % Promoteable People

Financial professionals are often too focused on applying metrics to a process as opposed to the underlying foundation behind the process; namely people. The emphasis should be on people since people are the glue that pulls together the elements of intellectual capital – processes, systems, knowledge, etc. Measuring and managing this “glue” is critical to squeezing value from all elements of intellectual capital.

The 360-Degree Evaluation Process

Managing human resource capital is now mission critical. One of the most effective tools for managing human resources is the 360-degree evaluation process. Traditionally, an employee is evaluated from a sole source (1 degree), namely the immediate supervisor or manager. However, employees interact with numerous sources: Co-workers, customers, Managers outside the employees department, vendors, contractors, and others. The 360- degree evaluation process relies on these multiple sources, providing a more balanced and objective approach to measuring employee performance. This leads to higher productivity, better customer service, and enhanced organizational performance.

“Every published report recommends multiple as opposed to single raters for performance appraisal.” – John Bernardin, Author & Expert on Performance Appraisal

When you tap into an employee's circle of influence, you will have a major impact on changing employee behavior. Additionally, employees often respect the feedback of co-workers more than their respective supervisor. A survey of Coca-Cola Foundation employees indicates that over 90% of employees prefer evaluations that include both co-worker and supervisor. Only 4% of employees chose to have their performance evaluations performed by the supervisor only.

Surveys are often used for collecting the feedback used to evaluate the employee. It is very important to keep surveys short and to the point. A few open comment questions can be included. However, you need an objective way of scoring the surveys. It is also important to maintain anonymity; i.e. receivers of the surveys should not know who provided the information. Likewise, the information received must be controlled so that confidentiality is maintained.

<u>Example of Survey Questions for Evaluating Employee Performance</u>:
Assign a score of 1 to 10 for each of the following questions. 1 is the lowest score (strongly disagree) and 10 is the highest score (strongly agree). N for Don't Know

	Score
1. Performs day to day activities in a timely and accurate manner.	____
2. Communicates effectively, both orally and in writing	____
3. Demonstrates initiative for solving problems	____
4. Directs and leads others in a positive way	____
5. Coordinates and manages time, people and other resources well	____

As with any new approach to managing people, the 360-degree approach requires careful planning. For example, training is a must since employees will be apprehensive about how this new evaluation approach will work. Training should address fundamental questions, such as what is the 360 approach, why is the organization adopting it, who will be doing the evaluations, how will the information be collected, etc.

The design of a 360-feedback process should actively enlist the employee. In fact, the employee should select their own evaluation team, consisting of no more than six targets (co-worker, supervisor, customer, etc.). Design of the surveys for feedback is also important since traditional approaches will not fit:

<u>Traditional Survey</u>	<u>360 Feedback Survey</u>
Single Target Audience	Numerous Targets (all employees)
Numerous Responses	Few Responses (5 to 7) per target
Response Rates may be low	Need High Response Rate for Objectivity
Respondent may be known	Respondents must be anonymous
Survey may be long	Survey must be short (less than 20 minutes)
Distributed through traditional ways	Electronic distribution is common

Control over surveys is low	Control must be high for confidentiality

Consistent rules must be adopted to make sure the process is fair for all employees. For example, you will need rules on when to throw out invalid survey responses. Some companies consider a survey as invalid when the individual response is more than 50% different than all other responses. Minimum levels are also needed for acceptance of surveys. For example, a required response rate of 75% is common where employee compensation is linked to 360 feedback results.
This article has touched on some of the basics behind the 360-feedback process. Multi-source systems, such as the 360 feedback, are more objective, accurate, creditable, and influential than traditional single source systems. By tapping into sources closet to the employee, we can better motivate and manage the employee. And since employees are at the center of organizational performance, we need fair and accurate methods for evaluating employee performance. The 360-degree feedback model is one of the best methods for driving employee performance and satisfaction.

Reintroducing the Human Factor

Out of necessity to compete and survive, the combination of innovation and technology are two focal points for management. The challenge for management is to make things happen through people, leadership, culture, and the organizational mindset. And this does not mean that everything must be done quicker, faster and at lower costs. The real benchmark to ask is: Does it add value to an existing process?

The driver behind this mandate (creating value through innovation and technology) is the management of people. With so much emphasis on profitability, things like people and innovation often get crushed in the mad rush to re-engineer the business. Re-engineering views the business in terms of excess, asking the question: What can we eliminate? Innovation on the other hand views the business in terms of re-thinking, asking the question: Can we do this a better way? Whereas re-engineering places little emphasis on people, innovation relies heavily on people.

If the organization fails to support its people, then creative thinking and innovation becomes elusive. A good way to understand this concept is to simply flip the organizational pyramid upside down. The CEO, who typically sits on top of the pyramid, is now at the bottom, providing upward support to the VP's (Vice Presidents). The VP's provide support to upper level management, upper level management provides support to middle level management, and so on. The lower levels of the organization are now front and center at the top of the organizational pyramid, supporting customers who in turn drive the business.

In his book, Leadership is an Art, Max De Pree describes leadership as "liberating people to do what is required of them." Employees are viewed as customers and the role of the Manager is to serve employees, attempting to optimize productivity. This point is also made in the book, Stewardship: Choosing Service over Self Interest by Peter Brock. Brock describes managers and supervisors as servants to employees, no longer controlling employees, but finding out specific issues confronting the employee and working through these issues to empower and unleash the human factor within the organization.

A network of employee-owned initiatives now re-energizes the organization into an entrepreneurial culture. Employees not only assume responsibility for valuing creating projects, but they share in the benefits and rewards; i.e. they have a piece of the action. Once employees are in control, they naturally find better ways of doing things - this is the foundation behind innovation. Management can begin targeting innovation at critical business areas, such as customer service, production, and marketing. To further move the process along, technology can be deployed into the mix. It's worth noting that technology alone is **not** necessarily the answer. Once again, we can go back to our fundamental benchmark: Does it add value to what is currently taking place?

All of this requires considerable change on the part of management. In his book Managing by Measure, Mark T. Czarnecki offers the following observation:

"Actual change takes real participation, not just listening. It takes real emotion and understanding . . We can ask people to change, but when we fail to redesign structures and systems around them, a lot of old behavior gets reinforced and new behaviors go unrewarded. Pay systems, leadership styles, job boundaries, technology, polices; if these aren't also changed, they merely serve to pull people back to where they were before the change process started."

Changing human behavior requires that managers put emphasis on people. And as author Mark T. Czarnecki has pointed out, a lot of things have to happen for this to occur - right leadership, right culture, right reward systems, etc. Therefore, the real test is how the organization itself changes in meeting the needs of the employee. For many organizations that have endured several re-engineering programs, reintroducing the human factor may offer the most effective and sustainable approach to continuous innovation.

Performance through People

Almost every organization says the same thing: People are our most valuable asset. However, when you see how people are actually managed, you have to conclude otherwise. Most organizations fail to manage their human assets for optimal performance.

"The performance challenge facing every organization is to develop management systems that make employees the organization's greatest assets."
- The Performance Challenge by Jerry W. Gilley, Nathaniel W. Boughton, and Ann Maycunich

The role of management is to find ways for getting people to perform. In the book Performance Improvement Methods, H. James Harrington and Kenneth C. Lomax outline ten barriers to performance:

1. Insufficient Time - Problems are not solved due to lack of time. However, the failure to solve a past problem creates a lack of time today.

2. Disowned - People fail to take ownership of a problem; i.e. it's not my job.

3. Not Recognized - People who deliberately go after problems are often not recognized. Instead, people are recognized for taking the path of least resistance.

4. Accepting Mistakes - The organizational culture may be too accepting of mistakes; i.e. everybody makes mistakes - this is normal. The mandate should be that when a mistake is made, we learn from the mistake so that the mistake is not repeated.

5. Ignorance - Lack of knowledge or awareness is not an excuse in today's competitive information age. Each problem requires some degree of attention or priority.

6. Impossible to Solve - People may conclude that the problem is impossible to solve. If this mindset grows, then more and more problems go unresolved.

7. Defensive - People will protect their turf, not assuming responsibility. People should respond by finding ways that they can contribute to resolving the problem.

8. Unrealistic Expectations - Management often imposes unrealistic requirements, usually in terms of time, quality or costs. Management must seek out realistic requirements by conferring with those who have to implement the decision.

9. Accepting Partial Solutions - People may accept a solution that partially solves the problem; i.e. it's good enough to get by. Instead, people should seek out the "best" solution and not the easiest.

10. Shifting Blame - People may target someone else as the source of the problem. The emphasis should be on trying to solve the problem and not pointing blame.

By removing these barriers, problems can be viewed as opportunities for value creation. Getting people into a problem-solving mode requires training and strong support from management. Additionally, the organization needs to be rich with performance improvement tools so that employees are empowered with the ability to solve problems. The list of performance improvement tools can be almost endless: Conflict Resolution Teams, Entrepreneurial Culture, Matrix Management, Strategic Benchmarking, 360 Feedback Systems, Risk Analysis, Competitive Research, Special Training Programs, Organizational Realignment, and so on and so on.

Improving performance is also a function of establishing standards and comparing actual results against these standards. This communicates "acceptable" levels of performance to employees. It can also push the organization towards "prevention" of problems. Programs like Six Sigma and Total Quality Management are often deployed for problem prevention.

Finally, one of the most potent tools for improving performance through people is to link performance to an employee's paycheck. Since people drive performance and the two are inseparably linked, you need to find some way of linking the two together (people and performance) through compensation. This leads to changing human behavior which is the ultimate goal of management.

"In the rush to change, many organizations have overlooked or mishandled what could be one of the most effective tools at hand - compensation."
People, Performance, and Pay by Thomas P. Flannery, David A. Hofrichter, and Paul E. Platten, The Hay Group

The Smart Organization – Part 1

Building a "smart" organization is a function of what many HR (Human Resource) professionals call Emotional Intelligence or EI. Unfortunately, many traditional managers think that a smart organization is full of highly educated people with high IQ's. In his book, Emotional Intelligence: Why It Can Matter More Than IQ, Daniel Goleman describes how Emotional Intelligence is a much stronger indicator of organizational performance than IQ (Intelligence Quotient).

“For star performance in all jobs, in every field, emotional competence is twice as important as purely cognitive abilities. For success at the highest levels, in leadership positions, emotional competence accounts for virtually the entire advantage.”
- Working with Emotional Intelligence by Daniel Goleman

Emotional Intelligence is the combination of skills, capabilities, and competencies that allow a person to deal with the pressure and demands of work. Goleman notes that EI improves with age and experience. Therefore, a young startup company full of 20 to 30 year olds will lack strong EI's whereas a company full of seasoned veterans should possess higher EI's. For example, a person's ability to lead a team or cope with business failure is a good indicator of EI. The good news is that EI (Emotional Intelligence) can be learned in the five components that make up EI:

1. Self-Motivation - The ability to cope and remain highly motivated
2. Self-Awareness - Strong insights into how people work
3. Empathy - Sensing and feeling the emotions of others
4. Managing Emotions - Understanding your own emotional strengths and weaknesses
5. Social Skills - Interpersonal relationships with others

Since emotional intelligence is somewhat unconventional, many organizations may view EI as nice to have, but unnecessary. Therefore, the first step is to understand the link between EI and various business needs. Fortunately, there is a wealth of research to support the impact of EI on business. Here are a few examples from the Consortium for Research on Emotional Intelligence in Organizations:

1. Research by the Center for Creative Leadership has found that the primary causes of derailment in executives involve deficits in emotional competence. The three primary ones are difficulty in handling change, not being able to work well in a team, and poor interpersonal relations.

2. For 515 senior executives analyzed by the search firm Egon Zehnder International, those who were primarily strong in emotional intelligence were more likely to succeed than those who were strongest in either relevant previous experience or IQ. In other words, emotional intelligence was a better predictor of success than either relevant previous experience or high IQ.

3. An analysis of more than 300 top-level executives from fifteen global companies showed that six emotional competencies distinguished stars from the average: Influence, Team Leadership, Organizational Awareness, self-confidence, Achievement Drive, and Leadership (Spencer, L. M., Jr., 1997).

4. In a national insurance company, insurance sales agents who were weak in emotional competencies such as self-confidence, initiative, and empathy sold policies with an average premium of $54,000. Those who were very strong in at least 5 of 8 key emotional competencies sold policies worth $114,000 (Hay/McBer Research and Innovation Group, 1997).

5. In a large beverage firm, using standard methods to hire division presidents, 50% left within two years, mostly because of poor performance. When they started selecting based on emotional competencies such as initiative, self-confidence, and leadership, only 6% left in two years.

6. At a national furniture retailer, sales people hired based on emotional competence had half the dropout rate during their first year (Hay/McBer Research and Innovation Group, 1997).

7. One of the foundations of emotional competence -- accurate self-assessment -- was associated with superior performance among several hundred managers from 12 different organizations (Boyatzis, 1982).

So you might be asking, how can I apply EI in the workplace. Several companies, such as American Express and Met Life, are using simple techniques to actively identify high EI employees. For example, weeding out pessimist from optimist can help distinguish self-motivation from a lack of self-motivation. People who are highly confident regardless of their assignments or jobs usually possess high EI's. Also, people with broad experiences adapting to different environments have strong EI's. Many companies now use EI testing for new job applicants, looking for employees with well-rounded skills (good team player, adoptable to change, communicates clearly, etc.).

Many experts trace a lack of EI back to our early childhood education. In his book, EQ: Emotional Intelligence in Leadership and Organizations, Robert K. Cooper describes an educational system that is dominated by math, reading, history, and other intellectual pursuits. Little emphasis is placed on emotional development and those things that give a person an understanding of how to deal with people. It's only through long years of experience that someone learns the five EI skills. And since most of us never learned these skills to begin with, it's up to the organization to recognize and develop EI related skills.

Emotional Intelligence cuts to the heart of high performance teams, attracting the right people, effective communication, and other desirable characteristics for the organization. If an organization wants to be smart, Emotional Intelligence must be a high priority.

The Smart Organization – Part 2

Part 1 of this article set forth the argument that "emotional intelligence" (EI) is the key to creating a smart organization. Since EI enhances individual performance, it also leads to increased organizational performance. In Part 2 of this article, I will outline some specific actions that every organization can take for transforming the company through emotional intelligence.

"Emotional Intelligence (EI) is linked to abilities that involve skill in managing the emotions in oneself and others and are predictive of superior performance in work roles. Research during the last twenty-five years has consistently pointed to a set of competencies such as Self Confidence, Initiatives and Teamwork, for example – that make a significant difference to the performance of individuals and organizations."

- The Emotionally Intelligent Workplace, Edited by Cary Cherniss and Daniel Goleman

In its simplest form, the fastest and easiest approach to building a smart organization is to hire people who possess strong emotional competencies; i.e. people who clearly demonstrate self initiative, self motivation, team leadership, self management, and other great people skills. Therefore, we can start by making sure the hiring practices of the organization take into account emotional characteristics of the job applicant. Second, an employee's performance review should recognize those emotional attributes important to job success. Third, employees need to receive training in EI.

Few, if any educational programs (including MBA programs) provide training in the field of emotional development.

Training should teach people how to become more adoptive, how to take initiative, how to resolve conflicts, and how to do your own self-assessments. For example, self assessments (which leads to self awareness) shows employees what their good at and what their not good at. Tests such as the Myers-Briggs Test are good tools for raising self-awareness. The 360 Degree Evaluation Process is also another good self-assessment process.

One misconception of EI is that some factors are more important than others. This is not true! People are different and jobs are different. Therefore, each person and each job will have its own unique set of emotional competencies:

Sales Staff	General Management
Self Confident	Self Managed / Achiever
Self Control	Builds Trust & Respect
Initiative	Social Communication
Social Empathy	Social Empathy
Influence Others	Awareness – Organization, People, Culture
Builds Relationships	Conflict Resolution

"Applications of emotional intelligence in the workplace are almost infinite. Emotional intelligence is instrumental in resolving a sticky problem with a co-worker, closing a deal with a difficult customer, criticizing your boss, staying on top of a task until it is completed, and in many other challenges affecting your success." – Emotional Intelligence at Work by Hendrie Weisinger, PhD

Finally, in her book The Emotional Intelligence Activity Book, Adele B. Lynn outlines ten steps every organization can follow for improving emotional intelligence:

1. EI should be used in all interactions with employees.
2. Give employees the power of self-assessments.
3. Help employees identify their behaviors – which behaviors help them and which hurt them.
4. Show employees how to change by setting objectives for improving destructive beliefs and behavior.
5. Expose employees to alternative thinking for adoptability.
6. Challenge employees to create new belief systems that not only improve their own performance, but the performance of others.
7. Encourage and reinforce the use of acceptable behaviors on the job.
8. Give positive feedback to employees when they improve their EI.
9. Measure the results in performance evaluations and other HR practices. Also share the results with the employee.
10. Practice what you preach – management must set a good example for EI if you expect others to follow.

"Emotion is present in the workplace. Everyday. Everywhere. Emotion is energy. Learning to harness this energy and use it to impact the reasoning side of the business in a positive way is one of the great untapped resources yet to be conquered."

- The Emotional Intelligence Activity Book by Adele B. Lynn

In conclusion, smart organizations are those organizations that hire, evaluate, and train their workforce around emotional intelligence. These smart organizations integrate EI into how people are managed. These organizations also leverage traditional IQ against EI, building real power behind business performance. There should be little doubt – emotional intelligence is fast becoming one of the most critical core competencies for every organization.

"We are in the beginning stages of what many authorities believe will be the next revolution in business. By design, no blood will be shed in this sweeping transformation from old to new, just a host of preconceived notions."

- Executive EQ: Emotional Intelligence in Leadership and Organizations by Robert K. Cooper and Ayman Sawaf

Humanizing the Financial Mindset

Financial Statements, Organizational Charts, Employee Handbooks, and all those traditional things that go into running the business are increasingly unreliable, out-of-date, and ineffective in a world driven by human and intellectual capital. If leaders of organizations are honest about high performance and creating value, then they must pay close attention to the human side of running the business.

"Unleashing Intellectual Capital . . is about the power of unmanagement. It is grounded on the inherent genetic tendencies of human beings, which have so far been almost totally ignored by business and other social institutions."
- Unleashing Intellectual Capital by Charles Ehin

For people in finance, it can be particularly challenging to "humanize" since business finance is so driven by numbers and shareholder value. In his book The End of Shareholder Value, Allan A. Kennedy contends that too much emphasis on shareholder value has led many companies to mortgage their futures away by doing short-term things (such as reorganizations) to boost shareholder value, but in the long-run, such tactics end up destroying value.

"Effective organizations possess a supply of employees willing and able to make contributions to organizational success. Organizational restructuring should

emphasize the most effective application of human resources to accomplish the organization's mission."
- Organizational Learning, Performance, and Change by Jerry W. Gilley and Ann May Cunich

Instead of focusing so much on shareholder value, the real focus should be on the relationships a business has with its customers, employees, partners, and other stakeholder groups. By investing in these stakeholder groups, you support those things that lead to higher shareholder value. This argument is well made in the Performance Prism, an alternative measurement model to the Balanced Scorecard; i.e. focus on your stakeholder groups before doing your strategy.

One simple approach to humanizing the financial function is to express financial metrics in relation to stakeholder groups. For example, we can "humanize" Economic Value Added (EVA) by expressing it per employee:

Value Added Employee (VAE) = EVA / Full Time Equivalent Employees

VAE has been popularized by Metric Performance (www.metricperformance.com), not unlike how Stern Stewart popularized EVA.

But we need to go beyond financial human metrics like VAE and focus on those things that enhance Human Resource (HR) Capital. In their book The Value Added Employee, Edward J. Cripe and Richard S. Mansfield outline three simple steps for increasing HR Capital:

1. Increase the number of high performers in the workforce. A combination of competency testing and performance evaluations are used to distinguish high performers from low performers.
2. Actively recruit high performers for building the organization.
3. Reduce or improve low performers in the workforce.

If people are the foundation behind performance and the goal is to increase shareholder value, then the real question to ask is: How do we secure a future for all of our stakeholders? A narrow focus on shareholders only has led us to witness the so-called bubble (overvaluations of publicly traded companies) and the subsequent market collapse.

" . . leadership is all about people, and if you're going to lead people you have to care about them."
- Encouraging the Heart: A Leaders Guide to Rewarding and Recognizing Others by James M. Kouzes and Barry Z. Posner

In conclusion, financial leadership requires an emphasis on those things that matter to people. Leaders need to be asking questions like: How do we build our business around the human resources of the company, what organizational structure best serves all stakeholders, and how do we improve how we manage our human resources. Those organizations that are overly pre-occupied with financial results only will be less profitable in the long run than those organizations that cater to building their human resource capital.

"Despite all the change swirling around any successful business, some things appear to remain constant for relatively long periods of time. Foremost is that business needs people to make it function, and people inevitably leave their mark upon it."
- The End of Shareholder Value: Corporations at the Crossroads by Allan A. Kennedy

Elevating the HR Function – Part 1 of 2

Organizational capabilities are developed primarily through the development of human resources. Despite the enormous importance of human resources, many organizations treat the HR (Human Resource) Function as just another administrative function with high overhead costs. As a result, the HR Function is often targeted for outsourcing and downsizing; crippling it from its real potential for value-creation within the organization.

Instead of viewing HR as a necessary administrative function, it's high time for all organizations to recognize that the real challenge for Human Resource Management is to lead the way on several strategic fronts - development of formal systems for creating a "learning" organization, effective deployment of human resources for maximum return to the company, and enhancing the competencies of the workforce. Senior Management should take a much broader and strategic view of the HR Function, using it to maintain or create new competitive advantages for the organization. Ultimately, the HR Function should be a major strategic player in how the organization executes its overall strategic plan.

"It has become increasingly clear that human resources (HR) in the future must operate strategically – not as the current 'partner in business', but as a business in and of itself. There are a number of critical reasons to move in this direction, not the least of which is that it may be the only way HR can take control of its own future."
- Tomorrow's HR Management, Edited by Dave Ulrick, Michael R. Losey, and Gerry Lake

In order for HR Management to become more strategic, it will have to reduce the administrative, paperwork that holds HR back. For example, things like virtual services - having employees doing their own training through e-learning or changing their benefits on-line will be the wave of the future, allowing HR to move away from pushing paper and doing more consultation type work.

Several factors are forcing change on the HR Function:
- New technologies (such as on-line time sheets)

- Competitive forces
- Organizational changes (such as changes in management, strategy, etc.)
- Increased pressure on HR to deliver services at lowest costs
- New challenges on HR to address strategic outcomes that impact the business

These factors and more will drive a major transformation in how HR will work. According to Ernst and Young, today's HR will contrast sharply with tomorrow's HR:

Today's HR Function = 70% transaction processing and 30% strategic initiatives.

Tomorrow's HR Function = 30% transaction processing and 70% strategic initiatives.

"The reason I think that strategic planning is important is simple. I have worked directly or through associate for more than five hundred companies in the thirty-two years that I have been a personnel consultant. Approximately two hundred of these companies were my direct accounts, so I knew them very well. Every one of these companies engaged in real strategic thinking and strategic planning as a core part of the style of managing has been successful by every measure of enterprise performance as long as they managed in that manner. Every company I have known for more than ten years that has shunned strategic activities in their management processes has failed and is no longer in business. That's pretty compelling evidence for me."
- <u>Strategic Planning for Human Resource Management</u> by Robert E. Sibson

If HR is to become strategic, then senior management outside HR must become more open-minded, accepting the critical role of HR in driving organizational performance. Once this new "strategic" imperative is accepted by management, then ideas will flow from HR. For example, many people in HR have good ideas, but they are rarely given serious consideration and commitment from senior level management. Even when HR attempts to launch a major strategic program, HR must go it alone with very tepid support from outside the HR Function. Ironically, many other non-operating functions such as finance and marketing have reinvented themselves into high-level decision support centers, using technology and processes for intelligent, strategic type decision making. It seems the re-invention wave never reached the HR Function, relegating HR to its typical role of administrative tasks – compensation, benefits, pensions, and basic personnel management. Therefore, senior management and HR need to form a strong partnership in making the move to strategic HR management.

"Your firm's human capital is a form of wealth that will create more wealth. When you enhance the value of your people, you enhance the value of your firm. A person's value as a human asset stems directly from how his or her knowledge, experience, skills, and competencies match the job in which that person works."
- <u>Valuing People: How Human Capital Can Be Your Strongest Asset</u> by Lisa M. Aldisert

In order to jump-start the strategic process, HR can embark on several "value-based" practices, such as team building, cross-functional development, linking pay to performance, and assessing individual performance. Even the most fundamental issues can be a good source for HR programs – things like effective communication throughout the entire organization. HR can test, monitor and improve various channels of communication, establishing standard guidelines and "best practices" for information sharing.

One compelling argument for making HR more strategic has to do with core competencies. The HR Function needs to place more emphasis on those things related to capabilities and competencies, helping the entire organization reshape itself so it can meet future expectations and demands. If HR fails to address this critical issue, then HR runs the risk of strangling and impeding the development of HR Capital.

HR will need to embrace a much deeper and broader purpose, reaching into new areas such as expanding the knowledge workers and improving the relationships between employees, managers, and customers. Part II of this article will outline more specific initiatives for making HR highly strategic.

"As more organizations have recognized the importance of human capital and knowledge management with respect to competitive success, it is reasonable to expect that HR professionals would be at the forefront of organizational leadership. Yet, to the contrary, the importance of activities performed by HRM units seems to be losing ground in a majority of organizations, while other functional areas (for example, information technology, operations, finance) gain greater and greater influence. It is essential for firms to recognize that people, rather than technologies or process, are best able to sense and make judgments that put structure around the inevitable disorder that results from these forces. Therefore, the knowledge economy, more than any previous market trend, places a premium on human talents. Consequently, the management of a firm's HR, more broadly defined than ever before, will be pivotal in determining the ultimate success or failure of the organization."
- Human Resource Management in the Knowledge Economy by Mark L. Lengnick-Hall and Cynthia A. Lengnick-Hall

Elevating the HR Function – Part 2 of 2

Part I of this article addressed the issue of elevating the HR Function into a more strategic type function, as opposed to an administrative type function. Part 2 of this article will describe several strategic ideas for moving HR into the strategic function it must become.

In Part I, we mentioned the importance of HR as it relates to core competencies. Organization's need to maintain and build their core competencies since this is the source of competitive advantages in the marketplace. Core competencies have a lot to do with recruiting and retaining the best people. Obviously, HR should play a lead role in this mandate. However, we do not want to stop here since there are numerous other strategic issues related to HR.

“The evidence is unmistakable: HR’s emerging strategic potential hinges on the increasingly central role of intangible assets and intellectual capital in today’s economy. Sustained, superior business performance requires a firm to continually hone its competitive edge. Traditionally, this effort took the form of industry-level barrier to entry, patent protections, and governmental regulations. But technological change, rapid innovation, and deregulation have largely eliminated those barriers. Because enduring, superior performance now requires flexibility, innovation, and speed to market, competitive advantage today stems primarily from the internal resources and capabilities of individual organizations – including a firm’s ability to develop and retain a capable and committed workforce.”
- The HR Scorecard: Linking People, Strategy, and Performance by Brian E. Becker, Mark A. Huselid, and Dave Ulrich

In his book, Strategic Planning for Human Resource Management, author Robert E. Sibson outlines several critical issues confronting the typical HR Manager:

- Productivity improvement
- Educational deficiency
- Delegative Management
- Fairness in the Workplace
- Managing Differences
- Fair Pay for Everyone
- Chronic Labor Shortage
- Impact of Technology
- Employee Owners (entrepreneurship in the workplace)
- Organizational Restructurings for Higher Performance

Each of these areas can represent a major strategic program for the HR Function. An absence of ideas is no excuse for making HR strategic. In his book The Human Equation: Building Profits by Putting People First, author Jeffrey Pfeffer describes seven dimensions that characterize how organizations produce profits through people:

1. Employment Security
2. Selective hiring of new personnel
3. Self-managed teams and decentralized decision making.
4. Comparatively high compensation contingent upon performance.
5. Extensive training
6. Reduced status distinctions and barriers (including dress codes, language, office arrangements, and wage differences).
7. Extensive sharing of information throughout the organization.

Once again, the sources for strategic initiatives are extremely significant. The obvious problem we will have is how do we address these issues within our typical HR Function. In order to elevate the HR Function so that it can meet these new demands, people within HR will require higher skill sets, including very strong technology type skills since many of the traditional HR services will be conducted through on-line service centers. Additionally, like most high quality functions, HR will need some "independence" from senior management, allowing the HR Function to pursue critical issues in an honest manner.

"The total transformation of Human Resources (HR) as a function has become both a business necessity and a strategic, value-adding opportunity. This transformation, which calls for a functionally fragmented, administrative cost center to a value-adding, integrated organization aligned with corporate business strategies, will not happen incrementally in most cases . . Instead, the true transformation of HR requires analysis and identification of opportunities for improvement in five interrelated areas that are the success drivers of effective HR, including the people in HR and their competencies; processes used to deliver HR products and services; the culture of the HR organization; its structure and the technology used."
- Web-Based Human Resources: The Technologies and Trends that are Transforming HR Edited by Alfred J. Walker

All of these strategic issues can be overwhelming to any resource-strapped function. Consequently, HR will need to develop its own strategy for value-creation within the organization; otherwise HR will not adequately address many of these strategic issues and outside managers will continue to have their traditional bias view of HR. The HR Strategy will need to address the issue of how the organization will build its HR Capital (which expands the capabilities of the organization). This can cover a wide range of best practices – web based training, knowledge sharing, 360-degree evaluation processes, cross-functional teams, and so forth. As a minimum, the HR Function must have a strategy for protecting the core competencies of the organization. Next, the HR Function will need to develop strategies for building a knowledge-based workforce that can meet future challenges confronting the organization.

"If competitive success is achieved through people – if the workforce is, indeed, an increasingly important source of competitive advantage – then it is important to build a workforce that has the ability to achieve competitive success and that cannot be readily duplicated by others. Somewhat ironically, the recent trend toward using temporary help, part-time employees, and contract workers, particularly when such people are used in core activities, flies in the face of the changing basis of competitive success. This raises the questions of why these practices seem to be growing, what effects they have on the ability to achieve advantage through people, and what the implications are for organizations that might follow a different strategy."
- Competitive Advantage through People: Unleashing the Power of the Workforce by Jeffrey Pfeffer

In order for HR to be successful with its new strategic mandate, it will need to "in-source" to execute its strategy since its resources are way too limited. For example, direct involvement by IT (Information Technology) will be required to launch new technologies in the HR area. Additionally, HR may have to outsource some of the day-to-day administrative activities so HR can begin to address strategic issues.

In conclusion, some of the most significant performance issues confronting any organization are rooted in human resources. This is why the HR Function needs to become much more strategic. Moving HR into a strategic partnership with management is now mission-critical. There are a multitude of strategic issues for HR to pursue, ranging from making the organization more fluid for the sharing of knowledge to making sure all employees have the tools to provide outstanding customer service.

"In the closing years of the twentieth century, management has come to accept that people, not cash, buildings or equipment, are the critical differentiators of a business enterprise. As we move into the new millennium and find ourselves in a knowledge economy, it is undeniable that people are the profit lever. All the assets of an organization, other than people, are inert. They are passive resources that require human application to generate value. The key to sustaining a profitable company or a healthy economy is the productivity of the workforce, our human capital. In the American economy, where over half of the gross national product is allocated to the information sector, it is obvious that knowledgeable people are the driving force."
- The ROI of Human Capital by Jac Fitz-enz

What People Need are Coaches – Part 1 of 2

There are plenty of programs to help build and develop human resource capital within the organization; things like personal balanced scorecards, emotional intelligence, and 360 Degree Evaluations. However, trying to implement these solutions is not easy. Additionally, many of these initiatives involve considerable effort with somewhat mixed results. What we need are very informal, straightforward approaches to managing people for higher levels of performance. The answer may reside in coaching. Coaching has been very evident in sports – we've all seen how great coaches can turn a team of players into champions. And now coaching has emerged as the hottest thing for managing people.

Coaching is a form of supportive relationship that elevates the employee to a level of maximum performance. Coaching is about interacting with people, teaching them to produce exceptional results for business. Coaching is for anyone who must manage someone else.

"The business community is finally realizing what sports experts have known and practiced for years: individual attention from managers is the surest way to unlock an employee's potential. The payoffs for becoming a manager-coach are clear:

productivity, efficiency, reliability, and profitability."
- The Coaching Revolution: How Visionary Managers are Using Coaching to Empower People and Unlock Their Full Potential by David Logan and John King

Coaching runs contrary to the traditional manager, things like control, rules, and heavy-handed mandates. Coaching is much less formal and more collaborative. Just like in sports, veteran (more experienced workers) are mixed with the new recruits to make sure people have a chance at success. Contrast this to the current sink or swim environment that many are thrown into, only to burn out under the intense demanding workload.

With increasing pressure to do more, not to mention the high levels of change, employees now more than ever before need high quality coaching environments. For example, in sports the coach immediately intervenes when he detects a player not performing to his or her potential. Coaches transfer their knowledge of the game, showing the player how to execute. Coaching exemplifies some of the best characteristics in leadership – a personal relationship between manager and employee, tapping into the emotions of the worker to drive high levels of performance, and effectively communicating and transferring the knowledge so the worker can apply it on the playing field.

"Organizations are the ongoing creations of people who work in them. Treating organizations as if they were huge machines, as is done with command and control, badly misunderstands the nature of the phenomenon. To sum up and simplify what I'm saying, coaching is a way of working with people that leaves them more competent and more fulfilled so that they are more able to contribute to their organizations and find meaning in what they are doing."
- Coaching: Evoking Excellence in Others by James Flaherty

Coaches often motivate and compel people to exceptionally high performance levels through great communication. There is great power in the spoken word and coaches use this technique all the time. Some of the best coaches use extremely powerful words to reach players in a language that makes sense. And they say it with passion.

"To be successful, you've got to be honest with yourself. Success rests not on ability, but upon commitment, loyalty, and pride. Success in anything in this world is 75 percent mental. In our league, most times the teams are evenly matched in ability and physically. And it is usually the team that is best mentally prepared on that particular day which wins the ballgame. Success is paying the price. You have to pay the price to win – to get there and to stay there. Success is not a sometime thing; it is an all time thing. You don't do what is right once in awhile, but all of the time – success is habit, winning is habit."
- Coach Vince Lombardi of the Green Bay Packers (from the book: The Essential Vince Lombardi by Vince Lombardi, Jr.)

Coaches are very engaged with their players, teaching them to think smarter and do things better. Coaches are very good listeners; they also learn and love to teach others what they know. Coaches dig deep into the emotions of others, creating a bond between the coach and the player. Coaches are extremely deliberate and forceful when it comes to:

1. Seeking out the most talented people
2. Defining results and holding people accountable for their results
3. Providing immediate feedback on how people can produce the desired results
4. Rewarding and recognizing people for their successes

"We must see people in terms of their future potential, not their past performance. Coaching delivers results in large measure because of the supportive relationship between the coach and the coachee, and the means and style of communication used. The coachee does acquire the facts, not from the coach but from within himself, stimulated by the coach. Of course, the objective of improving performance is paramount, but how that is best achieved is what is in question."
- Coaching for Performance: Growing People, Performance and Purpose by John Whitmore

One of the most significant dilemma's facing almost every organization is a lack of leadership. People desperately need leadership in order to perform. And coaching represents the essence of leadership. As author Ferdinand F. Fournies points out in his book Coaching for Improved Work Performance, Managers are not paid to get results, they are paid to get results out of other people.

Coaching is one of the most potent management techniques for improving performance. This approach to managing (coaching) is what drives performance in sports; so why not use it in the workplace? Coaching is what people are looking for from management and as a result, coaching fulfills the basic performance needs of employees. Coaching is truly one of the best ways to manage people. Part 2 of this article will outline some specific characteristics for transforming managers into coaches.

"Coaching lies at the heart of management, not at the edges. Coaching is everything you do to produce extraordinary results in your business with colleagues amid change, complexity, and competition. Coaching is everything you do to improve your strategic thinking about the business future you want to create. Coaching is everything you do to ignite personal and team learning in solving business problems while building the organization capability you need to succeed. It is everything you do to give you and your entire organization an edge and advantage."
- Masterful Coaching Fieldbook by Robert Hargrove

What People Need are Coaches – Part 2 of 2

Part 1 of this article laid the groundwork for transforming managers into coaches. Part 2 of this article will focus on what every manager can do to become a great coach. Much of this transformation from manager to coach is rooted in the relationships a Manager has with co-workers. In their book Stop Managing, Start Coaching, authors Jerry W. Gilley and Nathaniel W. Boughton describe nine key components behind a manager-employee relationship:

1. Freedom from Fear (think outside the box)
2. Communication (two way, not one way communication)
3. Interaction (Spend time with your employees)
4. Acceptance (non-judgmental)
5. Personal Involvement (get to know your people personally)
6. Trust (sharing, respect, openness)
7. Honesty
8. Self Esteem (focus on what a person is good at)
9. Professional Development

One of the key drivers behind an effective coach is being able to influence and teach others. Likewise, the best employees for the team will be those who are life-long learners; i.e. they enjoy having the coach teach them, learning new concepts, and applying knowledge to problem solving. Therefore, quality-coaching environments will require the right kind of manager (willing to spend the time on coaching) and the right kind of employee (very receptive to learning).

One of the key foundations behind coaching is the evaluation of performance data. Coaches use very quantifiable benchmarks of performance, comparing current performance against these benchmarks of excellence. Therefore, in order for a manager to be highly effective as a coach, the manager will have to:

- Establish a set of quantifiable goals in terms of time, money, or some other specific metric
- Collect measurement data on a regular basis to evaluate performance. Things like surveys or even casual observations can help. More sophisticated approaches such as the 360 Degree Evaluation Model can be used for consistency throughout the department or organization.
- Analyze the performance data, identifying the gaps in performance and areas for improvement. Working with the employee to close the performance gap.
- Once goals have been reached, establish a new set of goals and go through the process again to continuously make progress.

Perhaps the single biggest driver behind coaching is leadership. Coaches tend to have outstanding leadership skills. The legendary coach Vince Lombardi summed it up as follows:

The Lombardi Rules – The Winning Model

1. Know yourself – You can't improve on something you don't understand.
2. Build your character – Character is not inherited, it is something that can be, and needs to be, built and disciplined.
3. Earn your stripes – Leaders earn the right to lead, they manifest character and integrity, and they get results.
4. Think big picture – big picture is your roadmap and rudder. It can't change in response to minor setbacks, but it must change as the competitive environment changes.

- What it Takes to be #1: Vince Lombardi on Leadership by Vince Lombardi, Jr.

In conclusion, coaching is about assisting and collaborating with others to improve their performance in a one-to-one, personal relationship. Coaching is about becoming passionate over performance and results, conveying this performance in very measurable terms to people, holding them accountable for these measurements, and above all else, helping them get there. Coaching exemplifies the best qualities in managing since it offers what people need for optimal performance.

"To be successful as a people manager, you must recognize three very basic facts about your role as a manager:

1. Management is the intervention of getting things done through others.
2. You need your employees more than they need you.
3. You get paid for what your employees do, not for what you do.

If you accept these three basics, you will come to some very important conclusions about the most appropriate interventions necessary for you to become a successful manager. It also means that the more successful you wish to be in the business world, the harder you must work to do everything possible to help your employees achieve, rather than fail."
- Coaching for Improved Performance by Ferdinand F. Fournies

Neuro Linguistic Programming – Part 1 of 2

Managing and building human capital has taken center stage for many organizations. There are numerous tools to help enhance human resources, such as human resource scorecards, 360-degree evaluations, and matrix structures for cross-functional development. However, it would be nice to have one discipline to pull together the drivers behind human behavior and performance, defining the attributes and models that we need to replicate for building human capital. Well such a discipline has emerged – it's called Neuro Linguistic Programming or NLP.

"NLP is the art and science of personal excellence. Art because everyone brings their unique personality and style to what they do, and this can never be captured in words

or techniques. Science because there is a method and process for discovering the patterns used by outstanding individuals in any field to achieve outstanding results. This process is called modeling, and the patterns, skills, and techniques so discovered are being used increasingly in counseling, education and business for more effective communication, personal development and accelerated learning."
- Introducing Neuro-Linguistic Programming by Joseph O'Connor and John Seymour

NLP is a body of knowledge about how people think, sense, and communicate within their environments. By understanding these relationships, we gain insights into how to model the right kinds of behavior for outstanding performance and results. We can break NLP down as follows:

Neuro – Learning how we think and how it influences the results in our life. What people see and hear determines what they think. These reactions evolve into habits and habits will ultimately determine the destiny of the individual.

Linguistic – The languages we use for communicating. Understanding how we communicate has profound implications on results. And communication is more than what we say. Knowing how to communicate with yourself and others allows you to "code" or model conscious and unconscious patterns that produce favorable outcomes.

Programming – Everyone runs their life by programs or strategies. When people understand these programs, they begin to have more choices. And with more choices comes increased success.

If we pull together these three components, then NLP is a combination of thinking, behavior, and communicating for highly effective business relationships, team leadership, managing people, and other critical drivers of performance. NLP is the study of these relationships, applying a methodology of what needs to happen if you want outstanding results.

"There is nothing else in the world of human development and learning as powerful as NLP. It is our ability to manage our thinking, our conflicts, and our experience that will ultimately make the difference between those of us who will lead the way into an increasingly new, exciting, creative, and cooperative future, and those who will rapidly fall by the wayside as they attempt to follow. This is what we can learn from NLP."

NLP at Work: The Difference that Makes the Difference in Business by Sue Knight

In today's chaotic world of change and mixing of global cultures, NLP has become extremely important. NLP attempts to identify what works, not what should work. This is why NLP can be instrumental for business. Businesses are created and managed based on what management believes will happen. In fact, most people fail to comprehend and understand what works within themselves and thus, they are in a poor position to understand what works for business. NLP defines what works for you so that you can pursue the right options for success.

NLP maps out thinking patterns, identifying the preferred patterns. By learning how you think, you begin to change and manage better. NLP is about understanding performance gaps within the individual, what currently exists versus what can exist. NLP is about the quality of communication. Great leaders have a mastery of communication. NLP breaks down communication into three classes – visual, auditory, and feeling. NLP is also about programming – using models to reproduce someone else's situation and results, thereby gaining a much better understanding into how the individual thinks and behaves. The purpose of the NLP model is to produce the right kind of human resource capital for running the organization.

For example, models are often developed for several critical positions, such as Chief Executive Officer, Chief Financial Officer, and Vice President of Marketing. Many organizations have introduced NLP models into the workplace through mentoring programs. Mentors represent the NLP model that the organization wants for different positions. When a person aspires to the model, they become a mentor. Mentors serve as examples of what others in the organization need to aspire to. NLP also uses other type of models, such as Meta Models to flush out what really is being communicated.

This article has just scratched the surface of NLP. There are all types of test and models that NLP uses to build and enhance human capital. The bottom line for business is that NLP is about forming your own outcomes based on what you know works, not on what you think may or may not work. NLP is the science of understanding how people think and communicate. And how people think and communicate affects what they do. As a result, NLP can be a very powerful set of tools (all encompassed within one single methodology) for driving predictable improvements in people. Part 2 of this article will describe how NLP fits within the business environment.

"Change is a learning process and learning is a change process. Ultimately underpinning these processes are changes in the way individuals think and act."
- Changing the Essence: The Art of Creating and Leading Fundamental Change in Organizations by Richard Beckhard and Wendy Pritchard

Neuro Linguistic Programming – Part 2 of 2

One of the major benefits behind Neuro Linguistic Programming (NLP) is that it studies and models the skill sets of top performers within an organization. NLP Models give us an understanding of personal excellence. Some of these performance attributes are consistent, providing us with insights into how to model personal performance. In his book NLP Business Masterclass, author David Molden outlines several NLP attributes that relate to almost any type organization:

1. Real Innovation vs. Minor Improvement – In the NLP World, continuous improvement programs that tinker and create minor change are not good enough. Too much time and resources are expended trying to fix broken systems, processes, and other business issues. NLP pushes the issue to a higher level by focusing on new ideas and innovation to re-invent how things are done. According to NLP, the degree to which you depart from the old ways is determined by your beliefs. Traditional thinkers will depart less than non-traditional thinkers and this has profound implications on how much change will take place within the organization.

2. Feedback is Nourishing – Very strong feedback in a timely manner is critical in a world of rapid change. NLP does not put much faith in traditional long-term goal setting since things change too quickly and long-plans become outdated so easily. Instead, we must have very reliable and fast feedback systems to modify and direct resources in different directions, accepting the fact that failure will take place all the time and we will adjust as we learn about our failures.

3. Influence and Control - The ability to change is dependent upon the degree of flexibility. Rigid organizations and people are locked into the past, unable to influence and control what is happening around them. Flexible people will ask: How can I change and influence the situation and rigid people will declare defeat by thinking - They control and influence me and there is nothing I can do about it.

4. Resistance – A lack of rapport is a common problem, leading to a lack of acceptance from others in the workplace. If you don't have rapport, people will refuse to accept your ideas and beliefs. The key is to reduce the resistance level by establishing the right rapport. For example, there is a dramatic difference between telling people we are about to change what you are doing on your job vs. asking the person – What do you think we should do? NLP recognizes that you must deal with relationships in the workplace if you expect to gain acceptance.

5. Intention and Behavior are not the Same – People will easily misinterpret your intentions, however well intended. Therefore, you must work with others, realizing that your behavior and actions with others is going to have a profound impact on how they see your intentions. For example, it is better not to judge people, but to instead focus on how you can influence and get them to change their behavior and actions.

6. People can Change – People have what they need to change, but people need the knowledge and know-how so they can take advantage of the opportunities for change. Additionally, people must have a desire for success, providing them with a "thirst" for knowledge and know-how. Thirdly, desire for success must be connected to self-confidence and courage, giving people the ability to dream and stretch.

7. If one person can do it, then others can do it – One reason NLP has become popular is because it takes a look at what successful people are doing and asks, how can we apply this model to others. These NLP Models are powerful tools for understanding why certain people outperform others. People often limit their performance through their own behavior.

8. The Meaning of Communication is in the Response – Communication is only as good as the response you get from the person(s) receiving the communication. Too often, people assume they were effective with their communication, failing to recognize that communication is always subject to interpretation and easily misunderstood. When you get an unfavorable response from someone, change your approach to communication so that you can change the response you get back. Getting the right kind of response is how you should communicate.

9. Perceptions are Reality – No two people are going to think the same and therefore, you will have to recognize that how someone perceives things is how they think. For example, it is easy to distort perceptions with vague and incomplete communication, failing to include relevant facts or altering the truth. If you want perceptions and reality to be the same, you will have to be highly effective in how you communicate your perceptions.

10. I am Responsible – NLP recognizes that ultimately all behavior falls back on a person's state of mind. A negative state of mind will restrict a person's ability to influence and control a situation. A positive state of mind will allow the person to unleash high levels of influence on the situation, giving the flexibility they need to be successful.

One of the great benefits of NLP is the ability to better understand a person's map. This can be an extremely potent tool for improved customer service or any other interaction between people. For example, Diners Club used NLP to improve how managers communicate with customers, resulting in a 254% increase in customer spending and a 67% drop in customer losses. BMV used NLP to model successful communication techniques of its top 1% sales while American Express used NLP to empower managers with increased personal responsibility. Therefore, NLP does hit the bottom line since it provides a roadmap for personal performance and since personal performance is behind organizational performance, managers need to take a serious look at using NLP as part of how the organization develops its human resource capital.

"Unlocking individual change starts and ends with the mental maps people carry in their heads – how they see the organization and their jobs. Just as actual maps guide the steps people take on a hike through the Himalayas, mental maps direct people's behavior in organizational life. And if leaders cannot change individual's mental maps, they will not change the destination's people pursue or the paths they take to get there. As a result, successful strategic change requires a focus on individuals and redrawing their mental maps."
- Leading Strategic Change: Breaking through the Brain Barrier by J. Stewart and Hal B. Gregersen

The ABC's of Competency Models

As you drill down the drivers of performance for most organizations; things like great customer service, efficient processes, and empowering technology, you reach a base level for making these drivers happen. This gets you back to the qualities of your human resources – knowledge, expertise, experience, and those things needed for successful execution. And the combination of skills, expertise, knowledge and other intangibles will vary from job to job, function to function. For example, what we need for executing for securing new customers is not necessarily the same as what we need for efficient processes.

One of the more powerful tools for capturing the characteristics behind critical functions is the Competency Model. Not only does the Competency Model neatly organize success factors behind a position, but it also describes the behavior needed for maximum performance. Competency models can represent a key component for building an overall HR System. For example, we can use competency models for applying the same standards throughout the company. This helps reduce bias and unfairness in how we evaluate performance. Competency models also provide some basic benefits:

- Improves the likelihood of hiring the right person
- Provides a baseline for evaluating performance
- Gives insights into the training needs of a position
- Quick checklist of critical job qualities

In order to build a competency model, we should start by looking at past performance that elevated the position, resulting in very high levels of performance. What did this person do to make the position visible, creating value for the company? Try to reflect back on the behavior and actions this person took – special events, critical highlights, and other characteristics of success. What does success look like in this position? Interviewing current and past holders of the job can help. Look for common characteristics. We need to capture these qualities. Some examples might include:

- Flexibility – Able to adapt to sudden changes in the workflow to accommodate customer demands.
- Analytical – Easily applies skills and analytical tools to reach relevant conclusions.

• Team Building – Encourages and works well with others to achieve overall results.

From this baseline, we are able to articulate a model for exceptional performance, giving employees critical insights into what it takes to succeed. Some competencies will cut across several positions, such as similar skills needed for call center personnel, sales force, and marketing managers. However, the best competency models include some distinctions – such as assertive communicator for sales personnel, but friendly and courteous behavior for call center personnel.

A good competency profile is not easy to develop. For example, the best competency models incorporate the values and culture of the organization. Therefore, if someone performs really well in accordance with their respective competency model, then you invariably expect them to be rewarded and recognized within the organization. In reality, people who are rewarded and recognized may not be the highest performers. So make sure your competency models are backup by the reality of the values and culture of the company.

Another problem is going overboard. Competency Models are sometimes too idealistic and ambitious. Stick to the vital competencies that people can execute on. If you have several people struggling to perform, then go slow with your competency model. In fact, find out why people are struggling and see what's needed for your competency model to work within your existing workforce.

Finally, the best forms of competencies (knowledge, skills, etc.) tend to be behaviors. Behaviors are easier to grasp and understand. Employees tend to identify with acceptable behaviors as opposed to improving their skill sets. Once employees have reach behavioral thresholds, then move to higher skills such as leadership to drive long-term employee performance.

"Competency models are a means of ensuring that your investment in your people supports the achievement of strategic goals. The popularity of competency modeling is steadily increasing: human resource professionals and line managers everywhere are now using competency models to make wise decisions about selection and placement, as well as training and development and performance management."
- The Art and Science of Competency Models by Anntoinette D. Lucia and Richard Lepsinger

Organizational Development

Turnarounds for Distressed Organizations

Let's hope your organization doesn't find itself in a distressed situation. However, the first step is to recognize the early warning signs of financial distress. They include:

- Escalating inventory levels.
- Cash balances are relatively low.
- Some payables are paid 15 days late.
- Sales margins have dropped.
- Production has become inefficient and requires improvement.
- The Bank has called and asked for recent financials and additional information.

If you fail to take corrective action, than serious symptoms will occur:

- Cash balances are dangerously low.
- Checks are overdrawn at the Bank.
- Vendor payments are extremely late.
- You can barely make payroll.
- Layoffs have started.
- Employee morale is falling.
- Some of the better people are beginning to resign.
- Creditors and banks are requesting meetings.

When you reach serious levels of distress, you will be forced to implement a Turnaround Plan. The single biggest source of financial distress is by far due to bad management. So a change in management is critical within a Turnaround Plan. Bring in new partners, outside consultants, or someone who can think differently; someone NEW has got to enter into the picture! A second component of a Turnaround Plan is restructuring your organization so it can survive for the next 90 to 120 days. This requires extreme cost cutting, immediate liquidation of assets, and negotiating new terms on outstanding debts.

Next you will need to determine if the organization has a "going concern value" in excess of its liquidation value. Can your organization reorganize and generate values in excess of the values from selling off all of your assets? If yes, than you need to implement a long-term reorganization plan. If you are unable to reorganize and you can't meet your obligations, than you may have to consider Chapter 11 bankruptcy. However, voluntary reorganizations are preferred over Chapter 11. Finally, recognize the sources of organizational distress. They include bad management, inability to compete, too much debt, under capitalization, and lack of innovation.

Strategic Planning: Your First Step in Building a Balanced Scorecard

The foundation for Balanced Scorecards resides in a complete understanding of what is important to the future success of your organization. Critical success factors are identified through strategic planning. Strategic planning is a formal process whereby you prepare your organization for the future. Building a strategic plan is like building a pyramid from the top down. You start at the top with your mission statement and work your way down to the bottom by completing an Operating Plan. The layers in between represent strategic objectives and goals.

The overall process for building a strategic plan usually requires that you assess your current situation. A SWOT approach is quite common - Strengths, Weaknesses, Opportunities and Threats. Due to the enormous changes now taking place, I like to add a fifth area which I call Emerging Trends. Next you will isolate critical issues and categorize issues according to their probability of occurrence and significance to the organization. The following format can be used:

Place each critical issue within a grid according to Probability of Occurrence and Degree of Impact to Organization. Use three levels: High, Medium, and Low. Critical issues that are placed as High Probability of Occurrence and High Degree of Impact to the Organization must be addressed within the Strategic Plan.

You now have to reach agreement on how you will address these critical issues. This can involve scenario playing or simply establishing strategic goals. Some organizations will restructure the organization in order to meet critical issues. In any event, the end result is a draft strategic plan that clearly communicates direction and vision. Sometimes more critical issues will pop up when participants have a chance to read draft copies of the strategic plan. So make sure you encourage a flexible and open process. Strategic planning is very dynamic.

As a minimum, your organization should develop a strategic plan once a year. And you need to think strategically on a continuous basis. If you are new to strategic planning, a good place to start is with the Strategic Planning Workbook for Nonprofit Organizations. This book includes forms to walk you through the entire process. I use this book for **all** types of organizations, not just non-profits. You can order the book by calling 1-800-274-6024 (1-612-659-6024 outside the U.S.A.) or visit www.wilder.org.

The Importance of Knowledge Management

Most companies are focused on producing a product or service for customers. However, one of the most significant keys to value-creation comes from placing emphasis on producing knowledge. The production of knowledge needs to be a major part of the overall production strategy.

One of the biggest challenges behind knowledge management is the dissemination of knowledge. People with the highest knowledge have the potential for high levels of value creation. But this knowledge can only create value if it's placed in the hands of those who must execute on it. Knowledge is usually difficult to access – it leaves when the knowledge professional resigns.

"The only irreplaceable capital an organization possesses is the knowledge and ability of its people. The productivity of that capital depends on how effectively people share their competence with those who can use it." – Andrew Carnegie

Therefore, knowledge management is often about managing relationships within the organization. Collaborative tools (intranets, balanced scorecards, data warehouses, customer relations management, expert systems, etc.) are often used to establish these relationships. Some companies have developed knowledge maps, identifying what must be shared, where can we find it, what information is needed to support an activity, etc. Knowledge maps codify information so that it becomes real knowledge; i.e. from data to intelligence.

For example, AT&T's knowledge management system provides instant access for customer service representatives, allowing them to solve a customer's problem in a matter of minutes. Monsanto uses a network of experts to spread the knowledge around. Employees can lookup a knowledge expert from the Yellow Page Directory of knowledge experts.

In the book Value Based Knowledge Management, the authors advocate that every organization should strive to have six capabilities working together:

1. <u>Produce</u>: Apply the right combination of knowledge and systems so that you produce a knowledge based environment.
2. <u>Respond</u>: Constantly monitor and respond to the marketplace through an empowered workforce within a decentralized structure.
3. <u>Anticipate</u>: Become pro-active by anticipating events and issues based on this new decentralized knowledge based system.
4. <u>Attract</u>: Attract people who have a thirst for knowledge, people who clearly demonstrate that they love to learn and share their knowledge opening with others. These so-called knowledge professionals are one of the most significant components of your intellectual capital.

5. Create: Provide a strong learning environment for the thirsty knowledge worker. Allow everyone to learn through experiences with customers, competition, etc.
6. Last: Secure long-term commitments from knowledge professionals. These people are key drivers behind your organization. If they leave, there goes the knowledge.

Knowledge professionals will become the dominant force behind the new economy, not unlike the farmer was once the key player behind the agricultural age. By the year 2010, one-third of the workforce in the United States will be comprised of knowledge professionals. It is incumbent upon all organizations to embrace this need for managing knowledge. Just take a look at those organizations that seem to create value against the competition. You will invariably find a strong emphasis on knowledge management.

SWOT Analysis the Baldrige Way

Assessing your organization on a regular basis is a pre-requisite to strategic planning. One of the most widely accepted approaches for assessing strength's, weaknesses, opportunities, and threats (SWOT) is the Malcolm Baldrige Model. The Baldrige Model provides a structure for measuring and assessing organizational excellence by assigning points to various categories:

2000 Baldrige Template for SWOT Assessment
1. Leadership (125 points)
1.1 Organizational Leadership
1.2 Corporate Responsibility
2. Strategic Planning (85 points)
2.1 Strategic Development
2.2 Strategy Deployment
3. Customer and Market Focus (85 points)
3.1 Customer and Market Knowledge
3.2 Customer Satisfaction and Relationships
4. Information and Analysis (85 points)
4.1 Measures of Organizational Performance
4.2 Analysis of Organizational Performance
5. Human Resource Focus (85 points)
5.1 Work Systems
5.2 Employee Education, Training, and Development
5.3 Employee Well Being and Satisfaction
6. Process Management (85 points)
6.1 Product and Service Processes
6.2 Support Processes
6.3 Supplier and Partnering Processes
7. Business Results (450 points)

7.1 Customer Focused Results
7.2 Financial and Market Results
7.3 Human Resource Results
7.4 Supplier and Partner Results
7.5 Organizational Effectiveness Results

Let's quickly review the above template:

1. Leadership – An organization must have direction and guidance from an overall leadership system. Leadership systems include a balanced and strong executive management team, an effective organizational structure, and other attributes that allow the organization to move quickly without over-reliance on one single leader (such as the Chief Executive Officer).

2. Strategic Planning – Strategizing must be an integral part of the business and strategic planning drives much of what happens. Additionally, strategic planning has a quick turnaround; i.e. people spend most of their time trying to execute strategies as opposed to developing strategies.

3. Customer and Market Focus – You must clearly identify your customer and understand the marketplace. Customer requirements and their satisfaction are critical, but you must go beyond this and build customer alliances and relationships for customer retention.

4. Information and Analysis – You must collect quality data and transform it for timely and effective decision making. A performance measurement system (such as the Balanced Scorecard) and competitive intelligence are two primary components behind information and analysis.

5. Human Resource Focus – An overall human resource management system must be in place for maximizing human resource capital. This can include numerous components – hiring practices, compensation plans, recruiting, job design, reward / recognition programs, training, safety, and employee satisfaction.

6. Process Management – Products and services require various business processes. Numerous issues must be properly managed: Supply chain efficiency, consistency in delivery of products / services, quality improvement, control over defects / complaints, performance measurement, etc.

7. Business Results – The final category within the Baldrige Model are the results of the business. This is "proof positive" that you are successfully executing on the other six categories and as a result, almost half the points are assigned to this category.

The Baldrige Model has received worldwide acceptance as a means for gauging the health of an organization. Using the Baldrige Model as part of your strategic planning process is often considered a "best practice" in strategizing. You can also expand your analysis for more detail audits, leading to compliance with ISO standards.

Finally, the Baldrige Model may not cover all the information you need to properly assess your organization. For example, intellectual capital (culture, technology, knowledge, brand recognition, etc.) is becoming increasingly important. Don't forget to include these critical areas in your SWOT analysis.

Note: You can download Assessment Templates for applying the Baldrige Quality Model. Go to www.exinfm.com/training and download the supplemental material for Short Course 10. Case studies can be downloaded from www.baldrigeplus.com/eight.htm. Also visit www.efqm.org to download the EFQM Excellence Model.

Let's Define Best Practices

One of the most overused terms in business has to be: Best Practices. It seems everyone (including myself) is always labeling something as a "best practice." Thanks to Hackett Benchmarking, a common definition has emerged for best practices. According to Hackett Benchmarking, a best practice must:

1) Place the company in a top percentile ranking within its industry.
2) Leverage and take advantage of technology.
3) Improve quality and speed, and also lower costs.
4) Give management more control and influence.
5) And finally, it has to be working; i.e. it can't be planned but not implemented.

If you can measure up to these five standards, then you can truly boast about a best practice. And the benefits of having such a best practice will separate your company from the rest of the competition.

What makes this so appealing is that the gap between average performing companies and best in class companies is widening. According to Hackett Benchmarking, once a company has met the five standards for a best practice, it begins to pull away from the competition as it becomes easier to initiate improvements while average companies continue to struggle with process improvement programs. Making improvements without measuring up to best practice standards is like being in a row boat race. The best practice rowboat keeps moving ahead while you try to catch up at a slower rate of speed.

A good example of this is the financial analysis function. According to Hackett Benchmarking, average performing companies spend about half their time collecting data for analysis and the other half of their time actually analyzing it. Companies with best practices spend about 13% of their time collecting data for analysis and the remaining 87% analyzing and producing high quality information for decision-making. Therefore, the gaps between average and best practices can be significant.

Many companies that are considered best in class often follow similar strategies. For example, using one single standard throughout the entire organization seems to be a recurring theme. In the case of Enterprise Resource Planning (ERP), most organizations force fit many of their processes to the ERP application, thereby achieving standardization, consistency, and lower costs.

Another common theme is the use of self-service for both internal and external customers. Once again, technology plays a central role behind this best practice. Examples include having employees (internal customers) administer their own benefits through a web based application and having outside customers resolve their questions through another web based application.

Therefore, many best practices seem to strive for things like consistency, standardization, simplifying the process, zero redundancies, leveraging technology, single source for all data, and moving processes over to the internet. Finally, don't get discouraged – only a few companies can measure up to best in class. Now that you understand what it is and why it is important, you can begin your journey from average performance to best practices.

Elements of Sustainability

Long-term survival of any organization requires successful execution of strategies that secure or "lock-in" elements of sustainability. Unfortunately, not all organizations have made the distinction between sustainable strategies vs. short-term tactics that undermine sustainability. For example, the business model of amazon.com is somewhat predicated on becoming the lowest cost provider of books and CD's. In order to grow the business and make a profit, amazon must continuously increase volumes. This approach to strategy is not sustainable since it chases a lower and lower profit margin while at the same time, amazon must desperately try to make-up for the loss through higher volumes. A sustainable strategy tends to "lock-in" a company's future by doing things that don't exhaust the company, but set it apart from the competition. Hanging your strategy on easy to duplicate tactics such as lower costs usually doesn't work since the barriers to competitors are minimal.

Contrast this to a company that hangs its strategy on strong relationships with its customers, building loyalty and retaining existing customers. This "customer relationship" approach does a much better job of securing a company's long-term future. Therefore, elements of sustainability tend to be harder to execute on, but have much more lasting and enduring effects, adding to a company's long-term survivability.

Another important element of sustainability is branding of the business. As competition increases, it becomes increasingly difficult to get the attention of the customer. Therefore, strategic branding is now very important to many businesses.

Without name recognition in the marketplace, holding on to market share is considerably difficult.

Perhaps the single most important element of sustainability is the ability of the organization to change. An organization must adopt and move with changes in the marketplace. When a company can react and suddenly run in a different strategic direction without significant lead-time, then it has a much higher chance of prospering within the changing marketplace. For example, years ago Microsoft dismissed the internet as insignificant. However, once Microsoft realized that the internet was the future, the company adapted to marketplace changes and responded quickly by changing its overall strategy. What makes this remarkable is that Microsoft is no small company – it was able to shift suddenly, becoming a leader of internet technology. This type of fast strategic redirection is truly one of the key elements of sustainability. After all, strategy is conditional on other things happening. And if what you think doesn't happen, then you have to move quickly in a new direction.

This article has touched on three elements of sustainability – customer relationships, strategic branding, and the ability of the organization to change. Each organization is unique and elements of sustainability will vary from organization to organization. The common theme behind sustainability is to secure a future through strategies that move a company away from the competition; i.e. competitive advantages that are difficult for others to replicate. Too often companies make decisions that undermine their sustainability – cutting costs in areas like research, marketing, and product development or embracing strategies that are easy for competitors to duplicate. Sustainability is more about making "value" decisions that are right for all stakeholders over the long run and carefully observing trends and changes in the marketplace, giving the company insights into how it can outlast the competition.

The Art of Game Theory

One of the most challenging objectives for any organization is to make the transition from formal strategic planning to informal strategic thinking. Strategic thinking is one of the most powerful forces for creating value. In order to make this transition, we can look at business decisions in terms of playing a game. By applying this "game theory" to decisions, people tend to make strategic decisions in a very natural way.

Game Theory can be invaluable for effective strategic decision-making; answering questions like: What businesses should we compete in, what markets we should go after, should we partner with certain companies to survive, etc. The "game" represents your current strategic situation and "game theory" is the formal structure by which you make decisions within this strategic situation. Game Theory recognizes that decisions you make (as well as your competitor's) impact's the strategic situation.

"Challenged as never before with designing a high-value company game plan,

executives often get blindsided by competitors' moves they failed to anticipate. To safeguard against nasty surprises, you must think carefully about what actions competitors might take. Strategic Gaming – a structured, comprehensive approach to putting yourself in your competitors' shoes – enables you not only to play the competitive game more effectively, but also to create one that improves your value prospects by influencing other players' actions."
- Shaping Winning Business Strategies with Game Theory by Paul Papyoanou, Financial Executive Magazine, March / April 2003

Two opposing approaches to game planning are the Zero Sum Game and the No Zero Sum Game:

1. Zero Sum Game – Two companies are locked in fierce competition and only one company can possibly survive.
2. No Zero Sum Game – Numerous businesses exist and formulate their own unique strategies for market share. Each tends to play by its own set of rules. A decision matrix is sometimes used to plot moves, just like a sports team will plot moves on a play board.

For most companies, game theory resides somewhere between these two extremes. Developing a game plan usually consists of three basic steps:

1. Identify your key competition and map out strategies for those who threaten your market share. Depict the entire game for critical players and evaluate choices for winning against the competition.
2. Assign payoffs to various choices and plot the sequence of events. Determine which of these moves is most likely to occur through hard competitive intelligence.
3. Develop a plan for playing and winning the game that you expect to unfold.

Game Theory provides some interesting lessons in strategic thinking. For example, if you want to win at any game, then you have to have competitive skills. So if you are great at playing tennis, you should not try to compete at football. The same holds true in business – build on your competitive advantages instead of competing on things that are outside your core competencies. Also, game theory takes a "war" like approach to business, which in many cases is much closer to reality than ignoring your competition. Understanding your competition is critical to strategic thinking and game theory organizes the process as part of the planning exercise.

"For many organizations it is a dog-eat-dog world. In every commercial organization, there are talented people planning strategies to increase their business at the expense of the competition. Many noncommercial organizations find themselves under threat from those who provide their funds. The successful organization studies external threats and formulates a strong defense. It adopts this value: Know thine enemy."
- <u>Unblocking Organizational Value</u> by Dave Francis and Mike Woodcook

Although game theory has been around for years, it didn't receive recognition until it was the subject of a move titled: "A Beautiful Mind." Therefore, game theory is the art of looking at the strategic landscape in a much different way. Most people will fail to think this way, but game theory can provide a powerful framework for having this "beautiful mind."

"Game theory is a different way of looking at the world. In game theory, nothing is fixed. The economy is dynamic and evolving. The players create new markets and take multiple roles. They innovate. No one takes products or prices as given. If this sounds like the free-form and rapidly transforming marketplace, that's why game theory may be the kernel of a new economics for the new economy. "
- Co-opetition by Brandenburger & Nalebuff

Appreciating 'Appreciative Inquiry' – Part 1 of 2

In order to plan and look forward in a meaningful way, we need to first look back, appreciating the things we do well. It is those things that we excel at that gives us a strategy for a bright future. In a rapidly changing world, traditional approaches to planning often don't work. We assess strengths, weaknesses, opportunities, and threats, developing strategies to address a multitude of issues, only to have wasted resources and time trying to address issues that are difficult to control. Instead of this long exercise in planning, we need a much more rapid and direct approach to getting the organization and its people mobilized for the future. When we focus on the "positive" things that we do well, not only do we galvanize our resources better, but we also energize our people around things that they can accomplish. This simple and powerful approach to planning and change management is called Appreciative Inquiry.

Appreciative Inquiry is one of the most effective techniques for transforming companies since it tends to be very direct, very positive, very inclusive, and very real (rooted in past performance that works as opposed to untested fads that management forces upon the organization). Appreciative Inquiry is a way of thinking – acting on the "power points" of the organization, recognizing that if an organization wants more of something, it already exists! All you really need to do is to identify the things that currently work, what conditions allow this to happen, and how can we cultivate this to build a more sustainable future.

One obvious starting point is to get people engaged in a conversation about what's working. This is the "inquiry" part of Appreciative Inquiry. In every individual, team, department, and organization, there is something that works. What works becomes the reality or culture of the place. The act of asking questions (making inquiries) will create the positive influence on getting people to make progress. This can be extremely important for managing change since people tend to be more comfortable trying to execute things they currently do as opposed to forcing a whole set of new mandates upon people, not rooted in past performance.

If we expect to have a serious “inquiry” take place, then we need a viable learning environment. We can apply many concepts from the so-called learning organization, first pioneered by author Peter Senge in his landmark book The Fifth Discipline. Learning organizations provide the right catalyst for Appreciative Inquiry to work:

- People are more aware of what works and what doesn’t.
- The organization becomes more aware of what works and what doesn’t, providing the baseline for knowledge management.
- Visions bubble up from the bottom since we now have people engaged in a dialog of what to do. Senior managers who typically design the plans are now spending more time collecting the visions, developing strategies from these “mini” visions and putting a strategy in place that naturally fits with what people can execute on.
- Everyone has a strong opportunity to learn and freely ask questions. Nothing is sacred in the world of Appreciative Inquiry.

Learning organizations lend themselves to Appreciative Inquiry for a very simple reason – they communicate and share the “excellence” that takes place within the organization. This becomes the baseline for Appreciative Inquiry to work and if we can encourage this excellence, we have a real strategy for growth.

Sometimes a common theme may emerge, establishing the baseline – such as an organization that comes to realize that it has very strong brand appeal in the marketplace or perhaps, we learn and appreciate that our organization is perceived as a leader in quality customer service. Whatever the excellent themes are, the key is to recognize them and magnify them to lock-in a viable future. And one of the best things about Appreciative Inquiry is that the bad stuff (the things we don’t do well) gets de-emphasized. This frees-up limited resources, redefining a reality that we can sustain.

“Appreciative Inquiry was the catalyst for a positive step change in customer service at British Airways in North America. The use of Appreciative Inquiry transformed the entire organization in ways that we could not have imagined.” – Dave Erich, Executive Vice President, British Airways

Given the inherit difficulties with so many other approaches to strategizing, such as SWOT (Strengths, Weaknesses, Opportunities, Threats) Analysis and Scenario Playing, Appreciative Inquiry is posed to become a main-stream approach to strategic planning. And when combined with concepts associated with the learning organization, Appreciative Inquiry is a potent force for change management. In Part 2 of this article, we will outline the 4D Model of Appreciative Inquiry and link it to the learning organization.

“Appreciative Inquiry is both a process and a philosophy. It represents a frame of mind and a fundamental approach to life that is grounded in the positive, while being a process by which to appreciatively see and co-construct the world. In other words,

as people share with each other what they believe and think, they influence each other's views of the world. Together, people socially construct the worlds they live in creating meaning through social interaction. In an organizational context, as people talk to each other and share their views of the company, their work together, and their compensation plans, they create a shared understanding of the company – fundamentally the company as they see it."
- Appreciative Inquiry: An Alternative Lens for Rewards in the New Economy by Lia Bosch and Gervais Goodman

Appreciating 'Appreciative Inquiry' – Part 2 of 2

Simple things often work best – easy to design and implement. When it comes to strategic planning and getting the organization to move, Appreciative Inquiry can be the preferred approach because of its simplicity. In an effort to get Appreciative Inquiry working, we can follow the 4 D Model: Discover > Dream > Design > Deliver.

Discover: Start with a discussion about the best experiences within the organization. What conditions led to these great experiences? At what point did we really execute? What reward and recognition programs fueled these high points? What can we do to cultivate and build on conditions that create success?

One of the take-aways from the Discovery step is a common theme(s). Perhaps you are able to capture a new or better vision and strategy. Maybe roles and responsibilities get redefined. Whatever the deliverables are, we learn and create a set of critical conditions for future success. This is why a learning environment is so important to making sure Appreciative Inquiry will work. Without a strong learning organization, you really can't get past the first step of Appreciative Inquiry.

If you are not sure about how to create a learning organization, then consider these critical questions:

1. How adaptive is the organization to change; especially with external forces?
2. Is there a deliberate process in place for both individual learning and organizational-wide learning?
3. Does the organization have an open culture, encouraging new ideas and innovation?
4. Is the organization using with it learns, translating new knowledge into results?
5. Does the organization reward and recognize learning and growth?

Dream: Capture the various visions that exist throughout the organization. Establish strategic goals from the positive things already in-place – already doing it, but if we could do more of it, then this will happen.

Design: Specific action plans are now developed based on the value propositions from the Dream step. What actions must we take to realize our dreams? How best do we deploy resources to nurture these dreams? In some cases we may have to become more flexible – giving people increased opportunity to feel energized around these dreams. Perhaps we need more technology to empower the workforce or maybe a peer review evaluation process is needed to bind team members across functional areas. Regardless, you need to have a design plan for making the dream a reality.

Deliver: Once everyone concurs on the design plans, it's time to start doing it. Specific responsibilities must be established along with measures of accountability. It is also important to monitor the resource needs since assumptions from the Design step invariably require revisions. Therefore, the Deliver step of Appreciative Inquiry often leads us right back to where we started – discovering and learning new things, going through the 4 D Model iteration of Discover, Dream, Design and Deliver. And perhaps this is why Appreciative Inquiry is easy to implement, the ease at which we flow through the four phases, making progress with each iteration.

"Appreciative Inquiry is a complex philosophy that engages the entire system in an inquiry about what works. The inquiry discovers data that is then analyzed for common themes. The group articulates the themes and dreams of "what could be" and "what will be." *What will be* is the future envisioned through an analysis of the past. The entire system maintains the best of the past by discovering what it is and stretching it into future possibilities. This differs from other visioning work because the envisioned future is grounded in the reality of the actual past." - <u>What is Appreciative Inquiry</u> by Joe Hall and Sue Hammond

If you are seeking a simple and natural approach to planning, then Appreciative Inquiry warrants your attention. There is great beauty in simplicity and Appreciative Inquiry is one of the most beautiful things to happen to strategic planning in a long time.

Recommended Reading : <u>The Power of Appreciative Inquiry: A Practical Guide to Positive Change</u> by Diana Whitney and Amanda Trosten-Bloom

Is Knowledge Really Power?

We all recognize (at least I hope most of us) that knowledge is instrumental to value-creation and that knowledge as an asset is far more important than traditional assets such as equipment, real estate or buildings. And to a great extent, every organization must become a knowledge organization and that every employee must become a knowledge professional.

However, knowledge can be very messy – trying to turn tons of data into knowledge, not to mention the fact that the value of knowledge diminishes over time. Additionally, knowledge has little power in the workplace if no one shares it. Therefore, knowledge often lacks power. For example, knowledge is very inter-related; i.e. one part adds value to another part and when combined, knowledge has much more power as opposed to restricting knowledge to certain select areas. This is why competitive intelligence can be important since competitive intelligence pulls the pieces together for a "strategic" view of things, giving knowledge enormous power.

"It is evident that knowledge is rapidly becoming the firm's primary instrument of progress and competitiveness. Existing knowledge defines our productivity and competitive skill in the present; new knowledge determines our productivity and competitive skill in the future."
- Information, Organization, and Power: Effective Management in the Knowledge Society by Dale E. Zand

Even little things deflate the power behind knowledge – people are denied access to it, people are unable to use it or people fail to learn from it. Knowledge comes alive when everyone collects it, shares it, and learns from it. The internet provides an excellent example of how knowledge gains power – everyone can easily tap knowledge at the click of a mouse, making knowledge a common commodity just like water or electricity. Everyone uses the stuff to improve their quality of life.

In order to advance knowledge, barriers must be removed, allowing people access to it and communicating it in such a way that people can easily take advantage of it. By simplifying knowledge, we give people the power of knowledge since they can now execute on it. This is somewhat evident at my own web site – www.exinfm.com. I've attempted to "simplify" the knowledge of business finance, giving everyone instant access to it in a quick and simple form that is easily understood and applied.

"Companies survive on their ability to adapt when necessary, and it is increasingly necessary for them to do so. Successful adaptation is not, however, a chameleon-like response to the most immediate stimuli – a quick switch to a new enterprise or an impulse acquisition. Rather, successful adaptation seems to involve the thoughtful, incremental redirection of skills and knowledge bases so that today's expertise is reshaped into tomorrow's capabilities."
- Wellsprings of Knowledge: Building and Sustaining the Sources of Innovation by Dorothy Leonard-Barton

Knowledge becomes very powerful given the right kind of culture. For example, people are responsive to what is required within an organization based on the culture and authority that is superimposed by management. Knowledge becomes powerful when people share what they know so that collectively everyone is moving in the right direction. This requires a culture that rewards and recognizes learning and ideas. Additionally, people usually equate knowledge with some form of training, but the best forms of knowledge tend to be informal, whereby people increase their knowledge in an open learning environment (and this gets back to the culture of the organization).

Finally, you can assess if knowledge has power within the workplace. For example, it is important for people to understand the "big picture" behind an organization. Many employees are unclear on basic organizational things – strategy, organizational structure, who the competition is, and other overall facts related to the company. Therefore, a good starting point on your knowledge journey is to make sure people have knowledge about the fundamentals of the organization.

"Attempting to build a knowledge organization, however, is neither a short-term effort nor a one-off project. The process of becoming a knowledge organization can be visualized as traveling along the knowledge organization path. Some organizations are not even on the path, others are just starting on the path, and still others are further along. The underlying assumption is that those companies on the knowledge organization path envision and behave differently from the more 20th century companies. Those with knowledge orientation focus on ideas, creativity, and knowledge. They speak of 'intellectual capital' as opposed to traditional assets. Most important, the leaders of knowledge organizations fully realize that their most important assets walk out the door every night. Whether those assets show up the next day is of vital importance to the future of the knowledge organization."
- Leading with Knowledge: The Nature of Competition in the 21st Century by Richard C. Huseman, Ph.D. and Jon P. Goodman, Ph.D

Creating Creativity – Part 1 of 2

All people and all organizations possess creative talent. However, the world we live in can actually constrain creativity. This can range from organizational boundaries that limit our freedom to learn and grow to a society that tells us what to wear, what to eat, and what to look like. The real world of creativity has few boundaries, placing a high value on the spirit of new ideas. This invariably requires a large influx of mistakes and failures. Contrast this to the "non-creative" world where success is placed in a huge spotlight and the notion of failure is greeted with great displeasure.

Failure is a pre-requisite for creativity because real learning can only take place through a series of failures. So if you want high levels of creativity, then you must remove yourself from the many distractions that dummify the creative mind. It's almost like wiping the slate clean and challenging the assumptions that have guided all of your decisions up to this point. You keep asking the question – Why? You never real come to an answer, but you know you have to try just to learn from the experience. And in a few instances, a stroke of luck emerges and you discover something new. Therefore, creativity is very much a persistent pursuit of never being satisfied with the current set of solutions in place.

In his book Flow – The Psychology of Optimal Experience, Mihaly Csikszentmihalyi notes that people are most often creative when they enjoy what they are doing, but are challenged at or slightly above their skill level. Csikszentmihalyi says: “The best moments usually occur when a person's body or mind is stretched to its limits in a voluntary effort to accomplish something difficult and worthwhile. Optimal experience is thus something we make happen."

Some of the best lessons regarding creativity come from a study of the most creative people. Sylvia Nasar documented the brilliance of John Nash, a Princeton Nobel laureate, in her book: A Beautiful Mind. The contributions that people make are to some extent determined by what we choose to learn vs. what we choose not to learn. Thus, the way people work and live is paramount to one’s creativity. Nasar observed that John Nash was compelled to learn through experience. Learning without experience removes the element of failure, giving you a false reading on creativity. Nasar also noticed that Nash pursued those things not solved. Therefore, some of the most creative people have an appetite or thirst for solving things no-one else can solve.

Creative minds and organizations do have certain characteristics worth noting. Moshe F. Robinstein and Iris R. Firstenberg do a good job of documenting these creative attributes in their book The Minding Organization:

- Strong capacity for abstract thinking
- High tolerance for complexity
- Respect for facts and the ability to obtain meaning in a higher context
- Not distracted by unplanned events
- Usually possess high confident levels to get through the creative journey
- Embrace the discovery of learning
- Able to assimilate opposites

Finally, creativity is extremely hard work. The most creative people work very hard! It’s like trying to squeeze blood out of a turnip – you work with great intensity for that one random spark that can change so much. To ease the creative challenge, it’s often best to start with an attempt at building on what’s already out there. Innovation and ideas usually originate by looking at something already in place, but not looking at it in the same way. In Part 2 of this article, we will outline the Creativity Model for defining the full range of creative talents.

"Creativity drives growth, and creative people drive every great enterprise. It's not too trite to say that. These days, we're all too easily caught up in the tactics of competition. We can forget that sustainable advantage is ultimately a function of a company's ability to consistently generate, develop, and sell valuable new ideas. Which is to say, creativity is at the heart of work and business."
- John A. Byrne, Editor – Fast Company Magazine, December 2004

Creating Creativity – Part 2 of 2

One of the great misconceptions surrounding creativity has to do with new ideas. Most forms of creativity are not about new ideas. In reality, there are all types of creative talents that contribute to results. Creativity exists everywhere at all levels. The key is to understand these variations and know how to tap into them for creating value. Therefore, creativity is more about the full range of outcomes, not that one big idea. This broader approach to creativity is much more sustainable than the traditional and narrow approach of seeking some breakthrough idea.

The entire range of creative outcomes is well documented in the book Breakthrough Creativity by Lynne C. Levesque. Levesque has extended the Myers-Briggs Type Indicator into eight creative talents, providing us with a comprehensive "Creativity Model" for integrating creativity into everything the organization does.
1. Adventurer – Very spontaneous, detail oriented, and highly skilled in getting around obstacles.
2. Navigator – Somewhat cautious and calculating, righteous, very practical, and consistent.
3. Explorer – Enjoys discovering new things, brings about change, and likes to brainstorm.
4. Visionary – Sees things way into the future, can grasp complex situations, highly focused.
5. Pilot – Enjoys managing projects, decisive, clarifies how to get things done.
6. Inventor – Somewhat internal and private, great thought into how things work, good at creating conceptual models.
7. Harmonizer – Good at getting people to work together, builds consensus, diplomatic.
8. Poet – Strong value system, deep thinker, good communicator, somewhat reflective.

The real challenge is to recognize and leverage all of these eight creative talents. For example, a "Harmonizer" is very useful for nurturing a situation that has conflict and different viewpoints. A "Pilot" is very useful for outlining the detail steps for getting a project completed. Knowing how to place and mix these creative talents together is the key to unleashing enormous value associated with creativity. So one of the best roadmaps to creativity is to embrace the eight creative talents. Most people are gifted with two creative talents, a primary creative talent and a secondary creative talent. Therefore, if an organization wants to leverage all eight creative hot spots, then you will need a diverse group of people for covering all eight creative talents. The interplay of all creative members working together is the hotbed engine for creative results.

Once you have the full range of creative talents in place, you can use a team approach for maximum creative outcomes. To make sure the creative process works, you may want to set some creative ground rules for your teams:

1. Continuous flow of ideas – Initial ideas are often marginal and you must keep pushing and brainstorming around each idea to get to the next idea. It's also a good idea to walk away from your session and then comeback a few days later refreshed. This helps produce the highest quality ideas from your brainstorming sessions.

2. Clearly defined problem or objective – Make sure you drill down to the source of a problem. Root cause analysis or simply going through the so-called Five Why's can help.

3. Not afraid of conflict – Given a highly diverse group of people, expect some conflict. Conflict is not bad as long as you manage it properly. For example, never get personal in the process – try to stick to the factual information involved, things that are relevant.

4. Solid collaborative dynamics – Make sure the team is really working well and not stuck in some kind of food fight. If you have certain folks holding the creative process back, then deal with these issues immediately.

5. Implement the Team Recommendations – If the creative team process makes specific recommendations to solve a problem, then you should try to implement it; otherwise why did you form the team. If the team sees that its outputs are going no-where, then the whole process will dry-up fast.

In conclusion, most of us seem trapped within a narrow definition of creativity, looking only at certain types of outcomes, such as great music or artwork. Creativity is much more than great music or artwork. Creativity takes any form that adds value to the current situation. And the best structure for understanding this creative process is to embrace and build on the eight creative talents. This is a well-grounded model that any organization can start using today.

"We should also acknowledge that often society itself resists creativity. The artist or thinker may challenge long-standing beliefs or behavioral and political norms. Many of our greatest achievements occur precisely because a group of individuals acting in concert elevated the ethical, intellectual, creative, and social character of each group member."
The Hothouse Effect: Intensify Creativity in Your Organization Using Secrets from History's Most Innovative Communities by Barton Kunstler, Ph.D

Technology

What is a Data Warehouse?

One of the best ways to leverage intellectual capital is through a Data Warehouse. Intellectual Capital refers to the intangible stuff that creates value for a company, ranging from intuitive thinkers in the workplace to having great strategic partners within the value chain. Intellectual Capital is the main ingredient behind Market Value Added which is the additional value created over time above what was originally invested into the business. Therefore, it is imperative to find ways of expanding and leveraging intellectual capital. One way of doing this is to implement a Data Warehouse.

A Data Warehouse is a central location of data that combines all of the existing subsystems and legacy systems into one single structure. Applying this concept to the management of information is extremely important since most organizations have fragmented pockets or silos of information scattered all over the organization. When everything is located in one place, Manager's can capture all of the necessary information for decision making. Consequently, the main reason for building a data warehouse is to improve decision-making. The benefits of a data warehouse include better customer service, lower production costs, increased profitability, and quicker turnaround times for making decisions. One of the most powerful applications of a data warehouse is to engage in data mining. Take the following example on how to better understand the customer:

A clothing catalog company with over 2 million customers has decided to mine its databases and develop better customer groupings. Instead of coming up with the usual four or five segments, 5,000 different marketing cells were developed. For example, it was noticed that 850 customers had purchased a blue shirt and red neck tie. This data is important since these same customers are more likely to buy a navy blue jacket than the average customer. It may pay to send a special offer on navy blue jackets to these 850 customers. If the data is correct, the success rate could be as high as 10%.

One way a data warehouse can improve decision making is to improve the database itself. Business rules can be added to calculate valuable measurement information, such as inventory turnover rates or product margins. You can also eliminate dirty data during the course of building the Data Warehouse. For example, bad customer records, outdated names, and other bad data should be removed when building the Data Warehouse. Things can be done to make the data more user friendly. For example, the customer type code "599" doesn't mean anything, but if you change it to "NPO" it means non profit organization.

There are several approaches to building a data warehouse, such as virtual or dimensional. The dimensional approach seems to work best since it represents a true separate warehouse that is easy to navigate. Some other things to consider when building a data warehouse include:

- Design the Data Warehouse around the strategic goals and objectives of the organization.
- Don't throw all data into the Data Warehouse, load only the useful data.
- Get the best people you can find since design and implementation of a data warehouse is extremely difficult.
- Make sure you allow for growth - the data warehouse will need increasing storage, memory, etc.

This article has touched on the very high points in data warehousing. There is a lot more to cover, but the main point is to start moving in this direction since data warehousing is a powerful tool for leveraging intellectual capital.

eFinance Part 1: Basic Concepts

It seems that everything now has an "e" in front of it. Finance, like any other function, is subject to profound changes because of e-commerce. This article will outline some basic concepts for moving traditional finance into an e-commerce environment.

In the World of eFinance, complex decisions are made using sophisticated models that demonstrate what destroys value and what creates value. eFinance pulls together all stakeholders behind value-creation: Employees, customers, suppliers, etc. eFinance works 24 x 7 (24 hours a day, 7 days a week), providing instant knowledge to decision makers on an enterprise wide basis.

eFinance, like all e-business applications will consolidate and integrate business processes, sharing and distributing a process electronically for global collaboration. Additionally, financial data is transformed into business rules and intelligence, thereby enhancing the knowledge and intellectual capital of the organization. A database of knowledge, leveraged by mining tools is a major component of eFinance.

The technology for making eFinance happen usually consists of three layers:

1. Database servers that manage the data.
2. Application servers that distribute information to end-users.
3. Clients - Personal Computers, Laptops, Workstations, etc.

The term "client-server" is often used to describe the architecture of eFinance.

eFinance, like all e-commerce applications will involve unique risk:

- Integration of processes into one integrated system is extremely difficult.
- Critical applications may be down, resulting in major interruptions of business processes.
- Loss of personal interaction since everything is now electronic.
- Corrupted or compromised information.
- However, the benefits of eFinance are enormous:
- Increased productivity.
- Faster and better decision making.
- Better collaboration through a consistent, standard process.

One obvious benefit of eFinance is lower transaction cost. For example, according to the International Technology Group, on-line transaction processing can result in the following savings per transaction:

Activity	Manual Cost	On-Line Cost
Process Order for Purchasing Equipment	$ 65.00	$ 6.85
Issue Retail Invoice to Customer	$ 2.77	$ .88
Process Purchase Order	$ 130.00	$ 28.00
Customer Query	$ 22.00	$ 2.32

The goal of eFinance is to transform traditional financial functions into value-added services that creates and enhances value. eFinance delivers strategic financial information faster and sooner, not only about what happened in the past, but also giving you forecasts and insights into what will happen next quarter or next year. In today's competitive business world, eFinance has become a matter of survival. Next month, I will touch on some specific components of eFinance, such as e-procurement.

eFinance Part 2: Key Components

The basic premise for many financial systems will reside in a fully integrated, centralized system. This consolidated system is typically an Enterprise Resource Planning or ERP System. ERP Systems integrate all business processes together, covering a wide range of functions - finance, human resource management, customer relations management, supply chain management, etc. The challenge is to get all of these processes on-line in a real time, global environment. Web based applications are often deployed for meeting this challenge.

For example, e-procurement can be used to streamline the ordering of recurring purchases. No more purchase orders, no more phone messages and other administrative activities. People now spend more of their time finding the best quality supplies at the lowest cost. The best e-procurement applications will automate searching for prices, providing a list of suppliers and integrating the entire process into the ERP System.

Even simple task, such as distribution of financial reports should go on-line through web portals or private intranets. Centralized processing of payments should go on-line, such as paying travel and entertainment expenses to employees. This eliminates the costly manual process and integration takes place directly into the payroll system (part of ERP).

At the high end of ERP is Customer Relations Management or CRM. CRM is sometimes used in conjunction with Sales Force Automation or SFA. SFA will serve to acquire new customers by converting prospects into customers. The process is automated based on pre-defined criteria. CRM works to retain customers through direct personal service. One of the biggest challenges for CRM is to maintain a "personal touch" despite being an on-line service. Technologies such as telephony (voice over IP), real time chat rooms, and other interactive features can help provide the personal touch.

If all of this seems overwhelming, there are some options for rapid deployment at minimal cost. These options are covered by Application Service Providers (ASP's) and Business Service Providers (BSP's). For example, smaller companies may find that www.corio.com can accommodate complete financial accounting through corio's web site. Human resource functions can be outsourced to web sites such as www.employeeservice.com and www.oneclickhr.com. Customer support can be outsourced to www.liveperson.com. Sites such as www.salesforce.com can serve as SFA. Simple on-line storefronts for e-tailing are available through sites such as www.freemerchant.com and www.openmarket.com can even integrate your e-tailing application into your ERP System.

Although eFinance is often seen as limited to things such as electronic payments and distribution of financials, financial professionals may find themselves serving as the driving force behind a host of e-commerce applications. This article has just scratched the surface. Things now change by the hour and financial professionals must play major strategic roles in making eFinance and ERP happen. And to make matters more complicated, the components of eFinance and ERP are extremely diverse. If core competencies are insufficient in meeting this enormous demand for eFinance, then partnering with ASP's and BSP's should be considered.

The XBRL Revolution

The Institute of Management Accountants calls it the most significant thing to hit the accounting and finance profession since the invention of the spreadsheet. The AICPA, SEC, and other regulatory bodies are racing to implement it as fast as they can. It's called XBRL or Extensible Business Reporting Language.

XBRL is rooted in XML – Extensible Markup Language. XML uses a set of tags to describe the specific data. Now that the data is tagged with a specific description, the user can pick and choose which data to download. All of the detail contained in a set of financial statements is coded, telling you exactly what it is. For example, the net accounts receivable balance is tagged so that users can extract only this bit of information off the financial statement. All users (investors, regulatory agencies, internal managers, analyst, etc.) will be able to pull off exactly what they want from one extensible coded financial statement. And all types of applications can read XBRL.

Some key points about XBRL:

- XBRL is a standard for preparing, publishing, and analyzing financial statements for both public and private companies.
- XBRL is freely licensed so that software companies and various operating platforms can adopt the XBRL format.
- XBRL does not change any existing regulatory reporting requirements.

The SEC has already setup an XBRL repository within EDGAR Online. Vendors like ekeeper.com have released tools for converting to XBRL. Software vendors are starting to incorporate XBRL into their financial reporting applications. The big ERP vendors, like PeopleSoft, have joined the XBRL Consortium.

Some of the major applications scheduled to roll out for XBRL include:

- Enabled consolidation engines to streamline the consolidation of financial statements.
- Conversion and Web Based Tools for pulling multiple financial sources into one single repository.
- Due Diligence Tools to streamline M & A Analysis.

XBRL will change how financial statements are prepared and analyzed. All users in the supply chain will expect XBRL financials. Therefore, financial professionals everywhere need to understand the coming XBRL revolution. For more information, visit www.xbrl.org.

Comprehending the IT Challenge

For too long, finance has misunderstood and failed to comprehend the true costs and resources required for many IT (information technology) projects. Issues such as migration and integration are simply pushed off to the IT Department to handle. The two functions (finance and IT) struggle against one another. Additionally, finance does not define its role in relation to IT and vice versa; i.e. there needs to be a marriage of strategies. Likewise, some IT projects continue unabated with no supporting value analysis, leading to unacceptable ROI's (Return on Investment). According to Gardner Group, 51% of all IT projects go over-budget by more than 200%.

Since IT is a significant part of a company's strategy and a major driver for best practices, Finance needs to fully grasp the role and strategies of IT. One good starting point is to find solutions that fit with both (Finance and IT) strategies. A fully integrated and seamless end-to-end suite for running the business may provide a solution that fits well with both Finance and IT. For example, many organizations are fragmented with different business units and departments each running their own applications. The end result is a desperate mix of applications and platforms, contributing to enormous bottlenecks in information flow, redundant activities, increased costs, less control over data, and paralysis for the organization when it is forced to change its business model or scale up due to growth. And to compound matters, with each new release of an application, the migration difficulties grow making the IT challenge increasingly difficult.

Desperate Applications and Systems:

Human Resources => PeopleSoft
Financials => SAP
Budgeting => Microsoft Excel
Inventory => Microsoft Access
Customer Relations Management => Siebel
Supply Chain Management => i2
Business Intelligence => Cognos
Web Services => BAE Systems
Directories => Novell
Portals => Plumtree

Suppose we could take this entire mess and put it into one single platform where scalability and integration were built into a single suite of products. Instead of a patchwork of desperate solutions where everyone is doing their own thing, we pull every part of the business together into one system and put a single IT strategy in place that works for everyone. Additionally, we no longer view Enterprise Resource Planning as another IT project; it is now viewed as a rapid business transformation project for removing the enormous disparities that are strangling the company.

What throws a monkey wrench into this whole equation is when management initiates a project that creates disparity, such as a merger and acquisition or a reengineering project. And at the same time, Finance has failed to fully grasp the true costs of desperate systems and how it impacts negatively on the company. Therefore, the Non-IT parts of the business need to comprehend the IT Challenge of trying to turn apples into oranges because of disparity. Turning apples into oranges is not how data should be managed and from an IT perspective, the management of data is how the company gains its competitive advantage.

Now that we understand the disparity issue and its ramifications, let's discuss another common issue confronting almost every IT project – time. In his book Good to Great, author Jim Collins examined all Fortune 500 companies and found that a mere 11 could be classified as "great." One of the most significant drivers for moving a company into the "great" category was time. Great companies took their time, showing high levels of persistence and patience with major initiatives such as IT projects. Contrast this to most companies where there is a mad rush to put some quick solution or patch in place that buys a little more time. Great companies are careful and prudent in making sure technology really fits with the values, strategies, and competencies of the organization over the long run and not the short run.

Collins also points out that great companies use technology (such as Enterprise Resource Planning) to accelerate transformation and not to reinvent the company. IT projects are viewed as complementary to the strategies of the organization and not the essence of the strategy itself. The core values (leadership, customer relationships, innovative products, strategic partners, etc.) that drive the organization have little to do with technology. They have more to do with people and processes with technology as an enhancer or tool to assist with execution.

"The good-to-great companies never began their transitions with pioneering technology, for the simple reason that you cannot make good use of technology until you know which technologies are relevant." – Good to Great by Jim Collins

In conclusion, it's high time for Finance and other management functions to fully understand the real costs associated with desperate systems. Moving to one fully integrated suite of products may not please different departments, but it will have profound positive impacts on improving efficiencies and saving costs on an enterprise wide basis. Finally, don't forget that "great" companies have never viewed technology as the roadmap to reinventing the company. And great companies have always allowed "time" to work in their favor by giving people the flexibility to revisit the entire life cycle of IT – working through continuous iterations until IT really begins to work and mesh with value creation for the organization.

Leveraging Knowledge Management

It is ironic that so many companies have an abundance of knowledge, but fail to use it for managing the business. Knowledge is a critical resource that warrants much more attention. If we are serious about managing knowledge, then we need to embrace the concepts associated with knowledge management.

"Businesses, especially large ones, have little choice but to become information-based. To remain competitive, maybe even to survive, businesses will have to convert themselves into organizations of knowledge specialist." – The Coming of the New Organization by Peter F. Drucker

Knowledge Management is the process of pulling together people, systems and tools so that an enterprise wide structure is in place for efficient and effective decision making. Unfortunately, many companies view knowledge management as an IT project, trying to move information from one location to another. Although technology does play a role, knowledge management is more about understanding the resource and knowing how to leverage it for growing the business. And yes, technology (such as enterprise portals) is often deployed to help leverage knowledge. However, it may be more important to focus on the information itself – knowing how to classify it and analyze it before you give everyone access to it.

A much better approach to knowledge management is to clearly understand the intellectual assets of the business. This can include simple things like getting more out of databases (a common repository of information) or looking at strategic issues like properly identifying intellectual assets and understanding how they impact the business. The goal is to put the "whole brain" of the organization to work, getting all parts of the body connected and working together for driving performance. This usually requires some form of gap analysis – looking for gaps in your knowledge assets, building knowledge to fill in these gaps, and making sure you are using the knowledge that you currently have.

"Ultimately, intellectual assets have become more important than any other because only by means of knowledge can companies differentiate their work from their competitors."
- The Wealth of Knowledge by Thomas A. Stewart

As author Peter Senge points out in his book The Fifth Discipline, learning organizations are always expanding their knowledge, finding new ways of creating knowledge, moving it seamlessly throughout the organization and transforming it so that people have insights into what they need to do. This requires a knowledge infrastructure, comprised of numerous components such as databases, libraries, internal experts, research centers, outside information brokers, and other knowledge-based sources for plugging the knowledge gaps within the organization. It also requires measuring and managing the value of knowledge so that it truly fits within the organization. Many companies have created Chief Knowledge Officers or Chief Learning Officers to help propel this process.

Leveraging knowledge management requires much more than moving the stuff around through Lotus Notes. It's about having a culture and infrastructure that supports the knowledge needs of the organization. This requires strong leadership, unlearning of old ways, an openness to new possibilities, promotion of learning, and very seamless communication on an enterprise wide level. This also requires a willingness to learn from others regardless of who they are; i.e. you must be willing to face the truth if you expect to leverage knowledge. In essence, knowledge management is about finding the best ways of running the business. And in order to accomplish this, you must be willing to learn and use your newfound knowledge in new ways for managing the organization. If a company isn't managing its knowledge, then it isn't managing its business.

"All healthy organizations generate and use knowledge. As organizations interact with their environments, they absorb information, turn it into knowledge, and take action based on it in combination with their experiences, values, and internal rules. They sense and respond. Without knowledge, an organization could not organize itself; it would be unable to maintain itself as a functioning enterprise."
- Working Knowledge: How Organizations Manage What They Know by Thomas H. Davenport and Laurence Prusak

Is Web Services the Next Big Thing?

No technology since the dotcom revolution has received as much attention as Web Services. Imagine a world where business transactions are conducted over the internet with little or no human intervention. Imagine a world where hardware and software (applications, networks, devices, PC's, Cell Phones, PDA's, etc.) are all integrated through the internet, allowing seamless flow of business information across the entire value chain. And the good news is that no major investment in technology is required – existing infrastructures of all kinds are pulled together through a standard model. Such a vision of business is called Web Services.

"Web services will quietly transform the way you do business, whether you're ready or not. A web service application is simply a piece of software that sits between my partners and me and allows all these desperate systems to communicate more easily. So if we can reduce the complexity of connecting systems together, we can either reduce our IT resources or put them to better use to make companies more efficient and competitive."
- Harvard Business Review, September 2003

Let's illustrate an example of how web services can transform what you do. Almost everyone uses the internet to display documents using a web browser (such as Internet Explorer). However, there is limited functionality in how you can use this data when viewing it over the internet; i.e. you can display it, but you can't download it into a spreadsheet. Suppose we could go around the web browser and place the data directly into a spreadsheet or perhaps, we need to send data to our PDA (Personal Digital Assistant). Web Services is programming for the internet and since everyone and every organization is connected through the internet, the potential is enormous.

"Web services technology – which represents the next stage in distributed computing – will profoundly affect organizations in 2002 and beyond. Almost every type of business – from small organizations to large, global enterprises – can benefit from web services. Companies are already implementing web services to facilitate a wide variety of business processes, such as expediting the development of corporate software, integrating applications and databases, and automating transactions with suppliers, partners, and clients."
- Web Services: A Technical Introduction by Deitel & Associates

So how does it work? Web service's relies on a protocol called XML or Extensible Markup Language. XML places descriptive tags around data, making the data portable across all kinds of platforms and applications. From an IT (Information Technology) perspective, XML is the language for processing business transactions. Besides XML, web services uses three other protocols:

- SOAP (simple object access protocol) provides the instruction code that gives the XML data processing power in the web service world; i.e. we need to submit request, process the request, and get a response back.
- UDDI (universal description, discovery and integration) provides a directory of web services, similar to how you look up a business in the Yellow Pages.
- WSDL (web services description language) provides a description of the web service so you can distinguish different types of services being offered by service providers.

"There is much debate as to whether web services are an evolution or a revolution. My view on this issue was expressed in the title of a column I wrote for IBM developerWorks. The column was called 'The Web Services (R)evolution' because I think that web services are both an evolution of distributed computing and the launch point for a revolution in the way we think about building large scale systems."
- Web Services: Building Blocks for Distributed Systems by Graham Glass

Before you rush out and launch a Web Service Project, some words of caution are in order. Web Services has failed to really take off due to issues such as reliability, security, and scalability. Also, XML is a sword sharp at two ends – it makes data very portable, but it can more than double the data load since everything is wrapped in a descriptive tag for processing. Additionally, web services seems to be stuck as a basic message processing service, unable to handle business transactions that require logic and business rules.

However, for businesses that rely heavily on technology, web service's warrants some serious attention. Just like when the Personal Computer was introduced, the potential of web services is significant. Therefore, if you are serious about technology and business processes, then you need to keep web services on your technology "radar screen" since it could be the next big thing.

"Web services are much like the magic stone in the folk tale about stone soup. As the story goes, a soldier comes to a small town where there is little food. The soldier declares that he has a magic stone that would make a great soup. The villagers, one by one, not wanting to be left out, bring meat, vegetables, and spices to add to this magic soup. In the end, they all enjoy the soup and everyone marvels at how wonderful a meal could be made from nothing but a stone."
- Brave New Apps by Robert P. Lipschutz, PC Magazine, October 1, 2003

Start Thinking in Nano's

Breaking things down to the smallest units, namely the atom, is creating a whole new way of thinking. If we can change matter itself, then this changes how we make everything from soda pop to skyscrapers. This whole phenomenon is referred to as Nanotechnology. Although one can argue that Nanotechnology is still years away, it's starting to creep into many products – nano-particles that make clothing resistant to stains and automobile bumpers that are twice as strong with half the weight. Therefore, everyone in business better start thinking at the nano-level.

The term "nanotechnology" was popularized by K. Eric Drexler back in the 1980's. Drexler conveyed a vision of building things atom by atom, moving away from a world dominated by bulk manufacturing technologies. Although one can argue that Drexler's vision is still years away, nanotechnology is starting to take hold in numerous ways, giving rise to everything from nanomedicene to nanobombs.

For businesses, nanotechnology is not just about making new products, but also about making all products in a different way. Manufacturing processes will be radically more accurate on the atomic scale. This will unleash more flexibility in how we build things. Production systems will go from the current macro-level to a new micro-level. Therefore, nanotechnology will lead to much lower production costs and much faster production times. And since nanotechnology has the potential to impact almost every product type, it is labeled as a "general-purpose technology."

"Nanotechnology will require you to radically rethink what your core business is, who your competitors are, what skills your workforce needs, how to train your employees, and how to think strategically about the future. The buzz surrounding nanotech is comparable to that at the dawn of the digital revolution, which changed the face of how business operates. Unlike the internet, however, which applied new technology to many old processes and businesses, nanotech is about creating entirely new

materials, products, and systems (and therefore markets), as well as making existing products faster, stronger, and better."
- The Next Big Thing is Really Small: How Nanotechnology will Change the Future of Your Business by Jack Uldrich with Deb Newberry

Nano is defined as one-billionth of a meter (less than the thickness of a hair). With continued advances in science and technology, this micro-level world is now measurable. And now that we can measure things at such a basic level, we can understand it and manipulate it – giving birth to a whole new industry called Nanotechnology. Over 1,000 start-up companies have entered into the nano hunt, creating a flurry of patents for new materials in everything we buy.

Nanotechnology will touch almost everyone in some way – from the use of small-scale machines implanted into our bodies for treating cancer to the use of micro scrubbers for cleaning our air and water. In the future, we will build things with the fundamental building blocks that exist in the natural world, reducing all manufacturing costs down to essentially raw materials and energy. And now that things are moving rapidly from the lab to the marketplace, we all must begin to think in terms of nano's.

"The future of Nanotechnology? It may seem strange now, but within a decade or so the term is likely to vanish from syllabuses and portfolios and remain part of company names only as a vestige of the past. After all, nano denotes only size. Once work on that scale becomes routine, that buzzword will fade. But the physical world – medicines, metals, and even the roles the elements play – will be utterly changed by this revolution, all brought about by bits far too small for the eye to see."
- The Business of NanoTech by Stephen Baker and Adam Aston – BusinessWeek, February 14, 2005

Welcome to the World of Complex Adaptive Systems

More and more, business is a function of increased specialization. We see this in the form of outsourcing. We also are witnessing how technology is used to respond instantly to the distribution of products. For example, Wal-Mart now requires its top 100 vendors to use smart tags to track inventory items. These smart tags, referred to as Radio Frequency Identification or RFID relies on satellites to pickup the movement of inventory items anywhere anytime. Eventually, we will see this technology at the consumer level, shopping carts displaying your items and amount due as you drop them into the cart.

So what's behind this trend? Many leading experts have characterized it as Complex Adaptive Systems – the next evolution beyond the so-called learning organization. Most businesses are bogged down in major planning activities – things like formal strategic planning sessions. In an effort to break out of this stalemate, many businesses are in hot pursuit of knowledge management, business intelligence, and other techniques to make planning dynamic, real-time, and responsive to the fast changing world we now live in. But this may not be good enough in such a fast changing turbulent world. Organizations must adapt continuously to a changing environment, similar to how living things adapt in the natural world. This has led to the study of complex adaptive systems and its applicability to organizations.

Nature is always changing and adapting – experimenting with doing something different. These natural variations create some degree of confusion and chaos, but they also help ensure long-term survival. It's worth noting that most variations are useless to nature, but the few that stick make the difference between extinction and continued existence. These lessons have great merit for all organizations - some degree of chaos is natural for ensuring that systems are adaptive, enabling the survival of the organization. The study behind this connection between chaos, adaptability, and survival is grounded in complex adaptive systems.

"How does the natural world create such brilliant strategies? Put simply, nature is constantly considering a massive set of experiments through the generic process known as natural variation. These variations, apparently random in nature, test a wide range of survival strategies – changes in size, shape, color, mating behaviors, food preferences, internal chemistry, and much more. Most of these variations are failure, but a few of them succeed. The lucky few – those gifted with favorable variation – will live longer, reproduce in greater numbers, out-compete other species, and eventually come to dominate future generations."
- Reinventing Strategy: Using Strategic Learning to Create and Sustain Breakthrough Performance by Willie Pietersen

Complex adaptive system's is the study of natural systems – how they interact, adapt, and survive over time. But increasingly, the world of complex adaptive systems is making its way into the business world. We can learn a lot by simply understanding many of the characteristics behind complex adaptive systems:

1. Boundaries are not imposed from outside, but the organism is always testing boundaries, using them as focal points to force needed change for long-term survival. For most organizations, these boundaries represent management hierarchies, department silos, division offices, and so forth.

2. Continuous feedback is always in place to control the complex adaptive system. Two types of feedback take place – positive and negative. Positive feedback elevates the outputs whereas negative feedback would reduce the outputs. For example, as the temperature in your house drops, your thermostat gets the feedback and kicks on your heater, raising the temperature. This is negative feedback – adjusting the outputs up in relation to inputs that are dropping.

3. Emergence not planning is how things really get done. Complex adaptive systems follow certain natural laws or rules, but nothing is formally planned in advance. Unpredictability is a natural event in a nonlinear world. If things are linear, then you can influence the value of outputs through inputs. When confronted with complex

interdependencies, you will have to "emerge" with a solution. For example, the weather is a complex adaptive system and we adjust our clothing according to local weather forecasts (feedback).

4. Small changes in the world of complex adaptive systems are not ignored. These are referred to as "butterfly effects" – small change that ultimately brings about huge outcomes. For example, Enron failed to pay attention to inside warnings about its accounting problems. These small, butterfly type events can mushroom over time and lead to total collapse of the system. In the world of complex adaptive systems, there is extreme sensitivity to butterfly effects.

The world of complex adaptive systems has given great insights into what an organization must do to avoid extinction. For example, in the old days, we bought cameras that lacked film, flash bulbs, and other important sub-systems. Now we buy a camera with everything built in, connected and working together simultaneously. This is one of the lessons for business with complex adaptive systems – the need to get all parts of the business highly connected and working together for rapid adaptability.

If you have a strong command of the so-called learning organization, popularized by Peter Senge in his landmark book The Fifth Discipline, then you should seriously consider the next level of learning - Complex Adaptive Systems.

"To make a healthy organism, you have to put its fundamental systems into balance so the parts are working with each other rather than against each other. Organizations that are out of balance become stuck – unable to move forward. What's more, Darwin might have argued: Those organizations that remain stuck, become dead."
- Unstuck: A Tool for Yourself, Your Team, and Your World by Keith Yamashita and Sandra Spataro, Ph.D.

Decision Making

Major Pitfalls in the Decision Making Process

The road of decision-making is filled with numerous pitfalls and traps. These pitfalls are hard to discern since they are part of our normal decision making process. They include misconceptions in the decisions we make, a bias in favor of one option, falling prey to the status quo, and continuance with sunk decisions. The more complex the decision, the more likely you'll run into these pitfalls.

One of my favorite types of pitfalls is the *anchor*. Anchors prejudice your decision by introducing an estimate or idea before you have time to analyze the decision. For example, suppose you and I need to negotiate billing rates for my services. If you reviewed my web site, you clearly saw what my billing rates were. This information will force or anchor you to seek rates that are close to what you already know. Anchors influence your decision by leaving an impression. They are hard to avoid. You can reduce the influence of anchors by not exposing yourself to information that influences your decision until you've had time to think on your own.

Sunk decisions are another common pitfall. Here you are trapped into a past decision because you don't want to admit that you were wrong. So you continue to throw more resources into the bad decision. Technology type projects often lend themselves to sunk cost decision making. To avoid sunk decisions, seek out advice from people who are not involved in the project and recognize that failure is a normal part of decision making.

Finally, there is the status quo where you make decisions that tend to not rock the boat. This bias approach to decision making is common in organizations where change is hard to accept. Additionally, if you break away from the status quo, you open yourself up to more responsibility and criticism. Remember that status quo is not your only alternative and status quo rarely remains the same over time. Ask yourself if the status quo weren't around would you still make the same decision in favor of the status quo?

Try to be aware of these pitfalls in making decisions. And remember, the more assumptions you make in your decisions, the more likely you'll be confronted with these pitfalls.

Key Elements to Effective Decision Making

Effective decision making is paramount to the creation of value. And as things get more and more complicated, it's harder and harder to make effective decisions. So what are the key elements to effective decision making? According to Peter Drucker, the decision making process should make a distinction between generic conditions and unique situations. For the most part, many decisions are made as generic; i.e. you are facing a situation which is similar to another decision and you can therefore apply a set of rules and principles to the decision. A unique decision is not generic and thus you have no real guidelines to solve the problem. The biggest problem according to Drucker is that most managers try to force their generic type conditions into a unique situation. Peter Drucker also advocates the importance of feedback to make sure your decisions achieve their anticipated results.

Too often organizations are making decisions with an aggressive attitude that implies that we have the resources to implement our decisions and we can overcome any and all adversity. In reality this may not be the case. For example, projects like Enterprise Resource Planning will sometimes trap companies into a deeper and deeper hole. An endless flow of cash is poured into these technology projects with no real regard for honest feedback from users. If you're inside a hole, you need to stop digging! A much better approach is to take a trial and error approach or *incremental decision-making*.

Making decisions in steps or increments is often the preferred approach since all decisions are based on some assumptions. And these assumptions are easily invalidated by the introduction of new information. With incremental decision-making, you make adjustments along the way and correct your assumptions. In capital budgeting, we call this contingent claims analysis - building options into our projects so we can get out if we have to. Incremental decision-making lends itself very well to Financial Management. So the next time you make a financial management decision, go in steps with corrections along the way.

Learning to Think

It has been said that everyone must possess three transferable skills – the ability to speak, the ability to write, and the ability to think. The most elusive of these three is probably the ability to think. Unfortunately, many organizations prevent people from thinking. For example, a lack of consistent standards throughout the entire organization may contribute to wide variations in results, making it difficult for people to make the right decisions. Many companies are plagued with compliance type thinking; i.e. people "go along" with decisions to avoid retribution, not challenging the bad decisions that are about to be launched. Instead, we need a simple and consistent framework for decision-making that allows everyone to think the way they need to think. In their landmark book BusinessThink, Dave Marcum, Steve Smith, and Mahan Khalsa have outlined eight standards that define a common framework for organizational thinking. Here are some quick excerpts:

1. Stop rushing to implement solution after solution. Instead, focus on the real sources of the problem so that results, not some solution unfolds. For example, make sure you define the problem accurately before launching some major project.

2. Make sure you have hard evidence that a problem really exists. For example, you may want to measure the issue just to substantiate the problem and determine the extent of the problem.

3. Don't forget to quantify your solution through some form of analysis such as a business case that considers all the angles. The true costs of launching a solution may exceed the costs of simply ignoring the problem.

4. Get to the root cause of the problem. Many companies put out fires or plug leaks in the organization without drilling down to the source. Eliminate the source and stop treating the symptoms.

5. Allow people to explore and let them be "nosey" into things that may not be their business. By giving people this opportunity to make inquiries into new things, change becomes easier to implement for the organization. In fact, by letting people penetrate new territories, you open up more possibilities, leading to change.

"Those who get curious often get it right – no matter what – and this leads to tangible competitive advantage." – BusinessThink by Dave Marcum, Steve Smith, and Mahan Khalsa

Thinking is about understanding people and removing organizational impediments that force people to act and behave outside their norm. Thinking is about equalizing everyone so that it no longer matters where the idea comes from, just as long as we get the right idea. Thinking is about going through some form of due diligence before committing organizational resources.

Too often organizations resist these "reality checks" because of management egos. And according to Jim Collins, author of Good to Great, management egos are one of the single biggest reasons that good companies never make it to great.

At a time when most businesses are struggling and failing, and at time when more and more people are becoming increasingly independent and entrepreneurial in their thinking, the time has arrived for all organizations to learn to think. Organizations must put people in charge within a single and simple framework that makes good business sense. And by making this framework for decision-making simple, people will be able to execute.

How to Brainstorm

All people and all organizations have some level of creativity. Unlocking this creativity on a normal workday is considerably difficult, especially for solving complex problems and issues. One way to spark creativity for effective problem solving is through brainstorming. Brainstorming is an informal process of using a diverse group of people to get at the root causes of problems.

The basic steps for brainstorming are:
1. State the problem or objective
2. Set some ground rules / agenda for everyone to follow
3. Give everyone an opportunity to participate
4. Solicit ideas and put everything down for people to visually see (no ideas can be rejected until you go through consensus building).
5. After you have exhausted the generation of ideas, eliminate ideas that are not relevant or duplicative.
6. Finalize the process by reaching consensus on those ideas that warrant the highest priority. A system of voting (such as assigning points to each idea) may be required.

Brainstorming requires considerable diversity in order to be effective. So don't be afraid to mix it up, including all types of different people who can come at a problem from various points of view. Keep in mind you are trying to find a solution that fits and this requires a broad mix of people to flush out all possibilities from both convergent thinkers (important for consensus building) and divergent thinkers (important for the generation of ideas). Therefore, brainstorming requires a group of people with very diverse backgrounds and knowledge.

The first step in brainstorming is perhaps the most important since it requires a clear definition of the problem. The key is to make sure everyone comprehends what the issue is – What are we trying to resolve? Everything else feeds from this initial step and unless people understand the problem, ideas cannot be generated. Sometimes it's best to start by asking: What are we trying to accomplish as opposed to defining a specific problem.

Another important part of brainstorming is consensus building. This starts by allowing everyone to put forth their ideas. All ideas must be encouraged and put on the table before you go through consensus building. Consensus begins by connecting ideas together and removing those ideas that are redundant. Since resources are limited for addressing problems, priorities have to be established by assigning a level of importance to different ideas. This is the "nuts and bolts" behind consensus building.

Although brainstorming is best applied in a group setting, it can be appropriate at an individual level if:

- Getting a group together is not practical since you work in a very small organization.

- People are not interested in brainstorming
- The problem really doesn't require a formal brainstorming session, just need to run the ideas by another person.

A good physical setting can help facilitate brainstorming. Select a neutral setting with no distractions, including no cell phones. Six to twelve people is the widely accepted number of participants for a brainstorming session. And don't forget to bring plenty of markers, stick pads, voting cards, and other supplies to capture the session outputs.

Brainstorming is not appropriate for every problem. For example, analytical problems may not benefit from brainstorming since the range of possible solutions is usually very narrow. Brainstorming tends to be more appropriate where there are many possible solutions to a problem. Additionally, you may want to have a more formal structure for problem solving on complex issues, such as running the issue through a fishbone diagram.

Brainstorming is best applied for getting unstuck on complex issues in a fast and informal way. And since so many issues are complex, requiring rapid resolution, brainstorming is one of the best ways to generate a raw list of ideas. Once you have the ideas, you can further explore the ideas through other quality tools (feasibility testing, prototype models, surveys, etc.). Don't forget – brainstorming is not about analyzing and testing the ideas – it's about the mother of innovation – creating the ideas! And since innovation is so important in this fast changing world we live in, brainstorming can be an invaluable management technique for staying on the road of innovation.

To Blink or Not Blink

In the last few years, there has been an infusion of psychological thinking into the business community. One such example comes from the psychologist Mihaly Csikszentmihalyi in his book, Flow: The Psychology of Optimal Experience. Csikszentmihalyi studied the most creative people and pioneered the concept of flow, how people get into the highest levels of productivity and creativity – recovering a sense of harmony, getting around the chaos, and controlling one's own experiences to obtain real happiness.

More recently, we have seen Malcolm Gladwell, writer with the New Yorker magazine, rise to the top of critical thinking for business leaders. Gladwell's first book, The Tipping Point, is the foundation behind certain business models such as Starbucks. And now with Gladwell's most recent book, Blink: The Power of Thinking Without Thinking, the entire business world has become captivated, making Gladwell somewhat of a cult figure. Given all of this attention to Blink, it's worth exploring what "blink" is and whether or not we should all start blinking more.

Let's start with a basic premise - People in business often make decisions by going through an endless parade of meetings, deliberation, expert opinions, consultants, and so forth. Business people are drowning in an endless array of information and analysis – all pre-occupied with trying to come up with solutions to problems. However, Malcolm Gladwell has noticed that some people have an uncanny ability to make decisions by following their gut feelings or somehow they seem to follow some intuitive sense. These first impressions that all of us sometimes have can be quite accurate, but since we can't defend them in front of the boss or the board room, we tend not to act on them, instead opting for further analysis and downstream work.

This rapid-fire, instantaneous "blink" type approach to decisions, relying more on what we quickly process in our powerful, but hidden subconscious has stirred a major debate in how we go about making decisions. Gladwell illustrates several subtle, but real examples of how this works. Let's say you want to learn more about someone. You could talk to this person, asking questions, probing and analyzing things to develop an overall opinion. However, you might learn more about the person by simply visiting their house and picking up on clues about the person – what's in their bedroom, furniture, books, and the like. This subconscious approach can be incredibly powerful and accurate, allowing us to learn in a matter of seconds.

The art of blink thinking is aptly called Thin Slicing – taking a small slice or first impression to quickly make a decision. According to Gladwell – "Decisions made very quickly can be every bit as good as decisions made cautiously and deliberatively." Gladwell provides several interesting examples of how people thin slice in a matter of seconds with extreme pinpoint accuracy:

- Tennis legend Vic Braden who can "thin slice" when he observes a tennis serve, instantly predicting double faults every time.
- John Gottman, a psychologist, who after listening to conversations for approximately one-hour between married couples can tell if the marriage will end after 15 years.
- Wendy Levison, a medical researcher who based on conversations between doctors and patients can tell if the doctor is likely to get hit with a malpractice lawsuit.

To his credit, Gladwell makes it clear that thin slicing can sometimes throw you way off – especially if you lack broad experience and expertise. For example, some of us have an inner prejudice or pre-condition that somehow taller people are very intelligent and forceful as leaders. As a result, most of our Presidents and CEO's are taller people despite the fact that shorter people are just as smart and capable. Gladwell himself confirmed this dilemma when he grew his hair into an afro, confirming that racism plays a role in how police officers respond to motorist.

However, for difficult decisions thin slicing may have its place; especially when people are highly trained, acting alone without undue prejudice or influence. So if you can somehow know when to rely on the thin slice of thinking, then you will probably be just as accurate with your decisions as those who must go through volumes of analysis. And even if we are not sure about blink thinking, then we should at least be engaged in a conversation as a matter of curiosity since those who are curious usually get it right.