THE ELEPHANT IN THE ROOM

Idiom: ***"*** Elephant in the room"

Definition: An obvious problem that nobody wants to deal with but cripples a company.

Business is about problems: how to find them, understand them, and either fix or avoid them. Many people bravely talk about dealing with the "elephant in the room". Sure, it makes great sense to deal with the obvious problems of a company; however, we've also worked quite hard to focus on helping organizations prevent problems before they come to exist in the first place. This newsletter describes a few problem areas that can lead, with little warning, to dysfunctional, and ultimately unprofitable behavior. By understanding the characteristics of these problems, perhaps you can avoid creating your own "elephant in the room".

FOR THE DIFFERENCE OF A DOLLAR

Early in our careers at one of the companies we worked at, we began having operational reviews. One item that had to be discussed was factory loading, i.e., how much product should the factory produce in the coming period of time. In periods of strong growth, significant money is spent on capital equipment and incoming materials, so appropriate care must be given to understanding demand and factory capacity.

One part of this operations' review was predicting the revenue output for the upcoming fiscal quarters. Both the Marketing and Finance groups presented their views of business unit revenue predictions for the current and future quarters. As the Company was set up, both of these functions drew their future views of revenue from different sources, specifically different databases. In the case of Marketing, this view was driven by customer demand, while the Finance revenue view was derived from factory loading and available capacity. Typically, the Marketing view of future revenue was much higher than that of the Finance group.

In one review, the VP to whom we all reported noted that the current quarter was fully booked, and that as such, the Marketing and Finance revenue views should be the same in the current quarter. It was a valid observation, and the Marketing representative agreed to go off and understand how to better align his numbers with Finance.

So far, so good . . .

In the next review, the views were still different, and the VP harshly chastised both executives . . .

So the Marketing and Finance guys worked even harder to make these numbers, drawn from different sources, match more closely (because the VP made it very painful when any difference existed between the numbers . . .)

Both entities got much better at reconciling their numbers until one quarter the Marketing guy gave his number, and the Finance guy gave his number . . . and they were about $20 apart (in a quarter with revenue of tens of millions of dollars). The two guys looked at each other in dismay, for they feared the criticism of the VP, and quickly started looking at spreadsheets to figure out how this error still persisted.

The moment ventured into surreal when the VP now criticized the execs for wasting so much time on such an inconsequential difference. In that silent moment, I glanced over at the Operations guy, and he shrugged. Both he and I knew that the behavior being criticized, while dysfunctional, was largely driven by previous criticisms. The meeting ended with considerable frustration, despite the generally strong performance of the overall team.

Key Point: *Managers that use harsh criticisms to drive change inevitably create dysfunctional behavior, leading to a fear based culture, as opposed to a culture that is thought-based.*

MEASUREMENTS UPON REQUEST

One of the most fascinating interactions in business is that between an executive team and the board of directors. It is a surprisingly common event to see a mere question asked by a board member turn into a metric that everyone tacitly assumes should be tracked by the company.

This scenario typically proceeds along the path of "how does this compare to that?" The executives, in an effort to be responsive, agree to track the metric, and the board member feels good that action is being taken. However, it is important to understand that each metric that is measured has consequences; the measurement takes time, the knowledge that something is being tracked will create focus, and the behavior of the company will consequentially change, however subtly. But if a board member asked for something, being responsive feels like the appropriate thing to do, right?

Well… in a word, no. While it often feels right to measure things, and to be responsive in offering to gather information, following these instincts leads many companies to track many more metrics than makes sense or is the best use of company resources. Watching Board packages get thicker is not, in any way, indicative of companies getting smarter or necessarily working towards more profitable performance. In addition, it is not true that bigger board books result in smarter boards.

Our position on this is that metrics are incredibly important, and that the behaviors they will drive should be well understood by both the staff and the board. However, creating too many metrics seriously diminishes focus. Because of this, we strongly advocate the development of a solid strategy, with key milestones, and the development of a small set of key metrics that support the overall strategy.

This begs the question of how to handle the board member's request for data. It is important to be responsive: So take the request down. Go make the measurement. Take the time to understand the measurement and its importance. Finally, have a private discussion with the board member. In general, this leads to a healthy dialogue, while the company remains focused on previously agreed upon strategies and programs.

Key Point: *Metrics should be less not more. The addition of metrics should be considered a strategic question, with full understanding of their implications prior to implementation.*

COMPLEXITY

The business world is full of complexity. In understanding an opportunity, teams are often tempted to try to create business models that capture as many effects as possible. Too many or too complex models fail because the linkage to reality becomes very tenuous. In practice, complicated business models make very poor tools to understand or manage a business.

At other times, business leaders will present very simplistic visions of reality. The strength of a very simple message is that it is a powerful tool for selling an idea. The downside is that an overly simplistic vision, while easy to "sell", often lacks critical features that make it useful for running the business.

What we've found to work well is to begin with a very simple, powerful idea. Work with simple numbers, simple models and only add complexity when it is required for the model to reasonably reflect reality. It is critical that the model be simple enough to be tested against reality.

Key Point: *A simplistic view of a problem is almost always wrong, while a complex model of a problem is almost guaranteed to be unworkable.*

Key Point: *Strive to begin with the simplest possible view and add only enough complexity to make the model testable and trackable.*

OPTIONALITY

In business, it is very common to try to mitigate risk by creating options for the business. This is often discussed as "risk management" or creating "optionality" in a business plan. This falls along the path of "if this doesn't work, then our fallback position will be to redirect the technology towards the next market". These statements sound very good and seem a reasonable approach. However, we differ in our view from many, if not most members of the business community, in that we believe that fairly often the practice of "optionality" results in greater risk to the organization due to the lack of focus it creates, resulting in diminished execution of the primary strategic option.

In this discussion, it is important to draw a distinction between operational back-ups, like a diesel generator for situations where the power fails, and strategic options, like planning to switch products or markets if the initial plan fails.

In our view there is a very high cost for keeping options open. First, the active consideration of an option takes thought, time and money. Further, having "optionality" defocuses the team, makes risk appear smaller than it actually is in reality, and allows a plausible excuse to avoid making a tough strategic decision.

A while back, I read a research paper about the financial ramifications of different venture funding terms. Within the paper, the author argued that the proper way to view a venture-funding event was to look at the deal as a set of options. In the event that the company did very well, the terms would allow the investor to participate as an equity owner. In the case that the company did ok, another path for the investor would be appropriate. Obviously, in the case that the company did very poorly, different terms would be used to help the investor.

From the perspective of a financial contract, all of the different options available to the venture capitalist are structured to make the investment quite attractive. However, it is interesting to consider the possibility that these options-laden contracts may tend to remove focus from the truly central issues of solid business strategy, problem solving and operations.

Key point: *Attempting to keep multiple strategic options open prevents clean decisions and hides risk. Put the options on the table, think through them, and make the tough decisions and commit.*

Cheers,

The InSite Newsletter Staff

www.insitepartners.biz

