CHAPTER 1

Profits: The Reason a Business Exists

> The essence of a successful business is really quite simple. It is your ability to offer a product or service that people will pay for at a price sufficiently above your costs, ideally three or four or five times your cost, thereby giving you a profit that enables you to buy and to offer more products and services.
>
> —Brian Tracy, Chairman, Brian Tracy International

All too often, we hear and read in the business media business leaders proclaim: "Our focus is on increasing shareholder value." What is this value, and from whose perspective are they attempting to increase it? Using the definitions provided by titans of the business and investing world including Warren Buffett, Benjamin Graham, George Soros, and Peter Lynch, a shareholder with a short-term interest is merely a prospector. It is the long-term focused shareholder that is a true investor. These people are "owners of the business" in the true sense and those whose interests business leaders should be serving. Wall Street does not usually cater to their interests, and, all too often, business leaders cater more to Wall Street than to business owners. The evidence of this discrepancy between words and action surrounds us in the form of failed corporations, issues around excessive executive compensations, and accounting scandals of historic proportions.

Clearly there is a gap between what is being said and what actually is being done in this context. This gap can be translated most often into a differential of focus between short-term profit maximization and long-term sustainable profitability—on the surface it appears to be a case of harvesting low-hanging fruit. The actual causes of this phenomenon are complex and involve elements of human psychology, emotion, greed, and competitive nature. Here we look at only those aspects that are most relevant to the art and science of managing a business enterprise.

The core problem in this regard may well be linked to the historical concept of a public corporation and what exists in today's environment. The dilution of ownership and the resulting imbalance of power in favor of management are evident in the daily headline news. Government intervention in this arena in the form of limits on executive compensation and other related measures will not solve the problem. Perhaps it is time to reconsider the fundamental structure of what we call a public company.

Profitability Defined

What is profitability? Most commonly, it is understood to mean "profits." But that is not accurate. *Profit-ability* is the *ability* of a business to generate profits and it is an *ongoing state of being, a steady state* whereas profits are discrete *events in time*. In the context of long term versus short term, profits are the focus of short-term focused management whereas profitability is the focus of the longer-term focused management. We will see during the course of this book that only management that is focused on profitability is truly attempting to serve the best interests of the shareholders: the business owners.

Profits can be generated through superior operating performance as well as by using destructive short-term tactics such as unjustified plant closing, capability-destroying headcount reduction, and nonstrategic reductions in investment in new product lines and services. One name that comes to mind in this context is that of Albert John Dunlap, popularly known as "Chainsaw Al." Named by Conde Nast Portfolio magazine one of the "Worst American CEOs of All Time," he is barred by the SEC from serving as an officer or director of any public company as a result of his conduct at Sunbeam Corp. His formula for "increased profits and earnings" was to fire thousands of employees at once and close plants and factories. Wall Street loved him because of *his ability* to deliver higher earnings in a very short time. Investors (really prospectors) loved him for delivering high stock prices in a short time frame. Boards of directors loved him for his *performance*. None of these constituents bothered to ask the question that needed to be asked: What was the impact of Chainsaw Al's short-term profits-focused tactics on the *profit-ability* of the companies he was leading? Some very smart people lost sight of the difference between *profits and profitability*. During the course of his career and using his short-term profit-seeking management techniques, Chainsaw Al brought strong corporations, including Scott Paper and Crown Zellerbach, down on their knees. Dunlap was finally stopped when he attempted to use his methods to increase the share price of the Sunbeam-Oster Corporation. His plan failed when Sunbeam stock plummeted within four months after a dramatic temporary rise in price. It was discovered that Sunbeam's revenues had been padded because Dunlap had given large discounts to retailers that bought far more merchandise than they could handle. While this positively affected the income statement (albeit through some accounting creativity), the excess merchandise had to be shipped to warehouses to be delivered later and added to the inventory balance sheet account. Rising inventory made the investors suspicious, and they eventually panicked, bringing down the stock price of Sunbeam. Dunlap was fired and agreed to pay $15 million to settle a shareholder lawsuit.

Profitability is a function of the internal and external factors that have long-term implications. It is a matter of how a business enterprise structures itself internally as well as how it positions itself to face the external forces in the marketplace in which it competes. Both have a strong bearing on the long-term competitiveness of the business. The most important consideration in this regard is agility, a concept we explore later. Agility in this context is the fundamental ability of a business to respond quickly and cost effectively to external forces and to be able to execute internal strategies in the face of a constantly changing competitive environment. It is a key component of a profitable business enterprise and is actualized through its platform for execution. Agility in this sense is both operational as well as financial. The focus of this book is on financial agility.

The key external factors of financial agility include:

- Competitive landscape
- Regulatory landscape
- Industry fundamentals
- Economic conditions

These external factors are not in the direct control of the management or the business enterprise. The competitive landscape is a complex web of forces that act on the business entity and give it either a competitive advantage or a disadvantage, depending on how it has positioned itself facing externally as

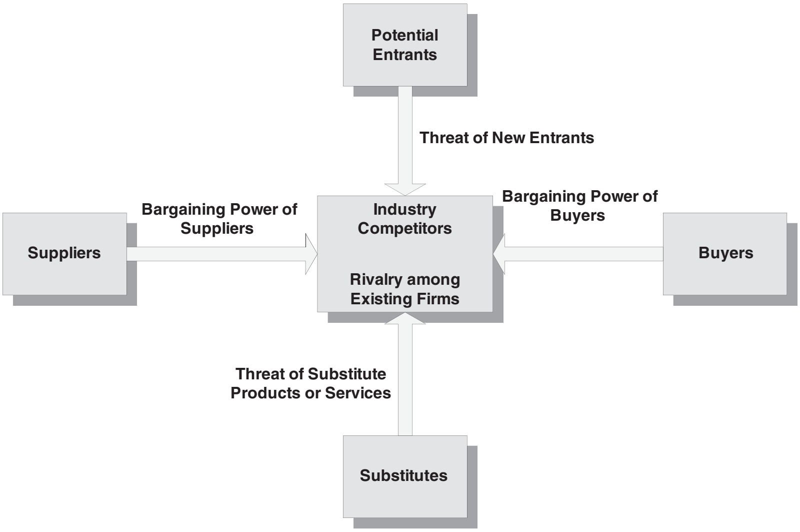


FIGURE 1.1 Porter Five-Forces Model

well as how it has organized itself internally. Michael Porter summarized this in his "Five Forces Model," as shown in Figure 1.1.[1]

Ample material has been written on defining this external environment and the various generic strategies that deal with these forces. What has been lacking is a blueprint for the execution of these strategies. As Larry Bossidy, retired chief executive of Honeywell, captured so well in his book *Execution: The Discipline of Getting Things Done*: "When companies fail to deliver on their promises, the most frequent explanation is that the CEO's strategy was wrong. But the strategy by itself is not often the cause. Strategies most often fail because they aren't executed well."[2]

The flawless execution Bossidy refers to is the domain of the internal factors of a business enterprise, which include:

- Organizational structure
- Organizational culture

- Capital structure
- Operating structure
- Management capabilities
- Upstream/downstream channel relationships
- The platform for execution

How a business chooses to carve out its market share is at the core an exercise in formulating its competitive strategy. At the highest level, it may choose one or a combination of the generic strategies—cost leadership, differentiation, segment focus. The rest of the internal factors then have to align with this core strategy decision. For example, companies that choose innovation as their core strategy must carefully plan and foster an *organizational culture* that supports innovation. A good example of this is Microsoft Corporation, where software developers are allowed a great deal of latitude in the work environment, including a very informal dress code, relaxed work environment, and casual interaction style with peers and even senior management. EDS, in contrast, has followed a *segment focus* strategy whereby it seeks customers and clients in large corporations that have traditionally valued a strict dress code and formal interaction style. Both are correct in fostering their respective cultures as each is aligned with the core strategy being executed.

Michael Porter gave this internal structure a name—the Value Chain—and suggests a generic representation as shown in Figure 1.2.

In essence, profitability speaks to the fundamental ability of the business to generate profits over the long term. Although sometimes profits may remain elusive due to external factors, the entity's ability to generate profits remains intact at its core and will give it a competitive advantage over the long term. Among the internal factors listed earlier, all are rather well understood except the last one: platform for execution. We

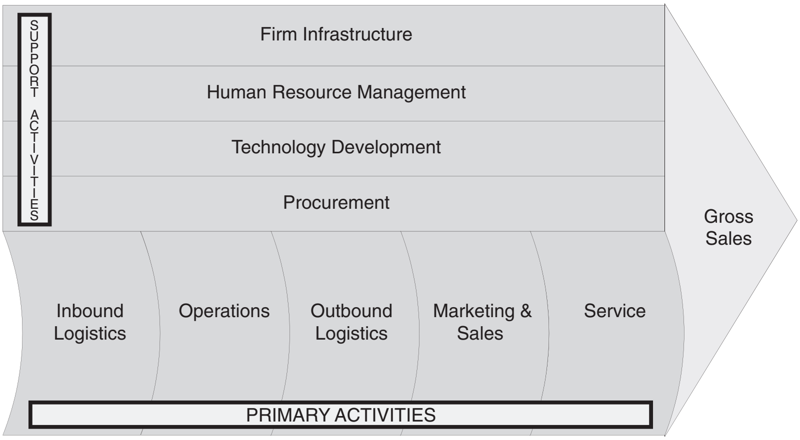


FIGURE 1.2 The Value Chain

Source: Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).

look at this in detail in Chapter 4, but for now, it is sufficient to understand that it is the digitized embodiment of the core business processes. It is what ensures that the strategies and resources of the business are leveraged optimally to maximize profits. Meddling with the profitability capabilities of a company during an economic downturn with the intention of cost cutting is an all-too-common mistake, and a tragic one. Leading organizations have learned to develop and invest in a platform for execution that does not need to be subjected to radical cost reductions for short-term reasons.

It is the primary responsibility of senior management to focus on the internal factors that determine business profitability instead of on the quarterly results that drive the short-term stock price performance. Investor relations can be a matter of taking or conceding control. If control is conceded to short-term "prospectors" to prop up earnings, those very prospectors will take their profits and leave, since everything that is knowable about the stock is already factored into its stock price.

This may help the short-term incentive compensation goals and profits objectives of some groups, but it does not necessarily turn out to be the right thing for the longer-term prospects of the organization. Lacking this long-term focus, intentionally or otherwise, leads to the eventual decline and even demise of the business. Examples of this are all around us: Think of Countrywide, Sunbeam, and Polaroid. All of them earned healthy profits for a long time due to superior profitability but neglected to stay focused on *profitability* and either filed for bankruptcy or ceased to exist altogether.

At the most basic level, we define profits as:

Profits = Revenue – Direct Costs – Indirect Costs

The area of controlling and minimizing direct costs is mature and attended to adequately by a majority of the business organizations through the use of supply chain management and procurement practices. It is the indirect costs—which constitute a significant portion of the overall costs—that are not as well managed. This is not to say that the importance of managing indirect costs is not well understood. Rather, the manner in which costs containment is undertaken by a vast majority of the business enterprises is not aligned with the best interests of shareholders—enterprise value creation. The management techniques most often employed in this regard are reactive in nature and do not contribute to long-term profitability. When I have asked audiences in seminars and presentations to share what comes to mind when they hear the phrase “cost reduction,” the answer always is “headcount reduction.” Yet it does not have to be this way, nor should it be. The up-and-down, yo-yo effect of hiring and firing is destructive to the very precious resources of human capital so often spoken passionately about by senior managements across the country. There has to be a better way, and there is. This is the realm of *profitability* and *platform for execution* that is the focus of this book.

In later chapters, we examine this area more closely and see some best practices that help maximize profitability by streamlining and leveraging back-office capabilities to minimize this yo-yo effect. Some layoffs may be unavoidable; but many others are due to a lack of process optimization, automation, integration, and standardization that cause this value-destroying phenomenon.

Profitability Equation and Related Metrics

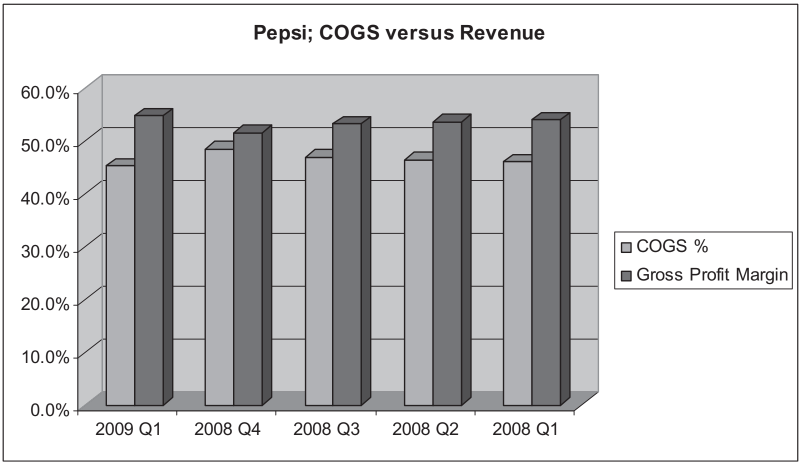
Profitability of a business enterprise is analyzed and measured in various ways, depending on the objectives of the analysis. Some of the most common measures are:

- Return on sales (ROS)
- Return on equity (ROE)
- Return on assets (ROA)
- Return on invested capital (ROIC)

The basic economic viability of the industry in which a business competes is determined by its gross margin, defined as:

$$(\text{Net Revenue} - \text{Cost of Goods Sold})/\text{Net Revenue}$$

Although this metric varies somewhat from one firm to another within the same industry, its limits are defined by the industry as a whole. As an example, Dr Pepper Snapple Group and Pepsi Co. compete in the beverages industry segment with an order-of-magnitude difference in revenue size, with Pepsi having the larger share. In spite of the advantage enjoyed by Pepsi due to economies of scale, the cost of goods sold (COGS) metric for both organizations is very close, as depicted in Figure 1.3.



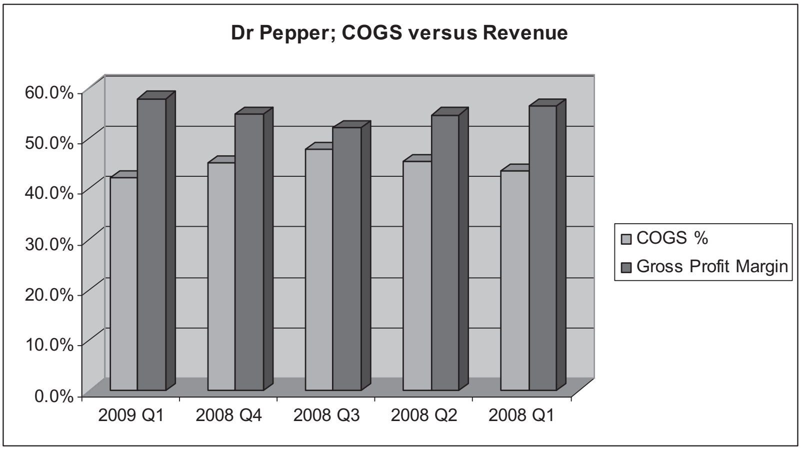


FIGURE 1.3 Cost of Goods Sold and Gross Margin

Excellence in this particular area is determined by internal capability in the procurement function. This function lies at the heart of physical supply chain management, which has a parallel on the finance side: financial supply chain, a topic we explore in detail in Chapter 3. The near equality of the ratio of COGS to revenue between the smaller Dr Pepper and the larger Pepsi indicates carefully designed and managed supply chains that close the advantage gap between the two companies in this area of margins. Although Pepsi may have more leverage with its upstream and downstream channel partners, Dr Pepper has arranged its physical supply chain to close this gap. In a similar manner, Pepsi may have advantages on the financial supply chain side, including access to capital on better terms and banking relationships that are favorable compared to its competitors. How Dr Pepper has designed, invested in, and manages it financial supply chain compared to Pepsi will determine which one of these two competitors has greater profitability—the ultimate measure of success for a business enterprise. This advantage is gained and sustained or lost in the financial back office as embodied in the platform for execution. A comparison of the efficiency of the financial back-office of these two competitors can be made by looking at their cash conversion cycle and its components, shown in Figure 1.4.

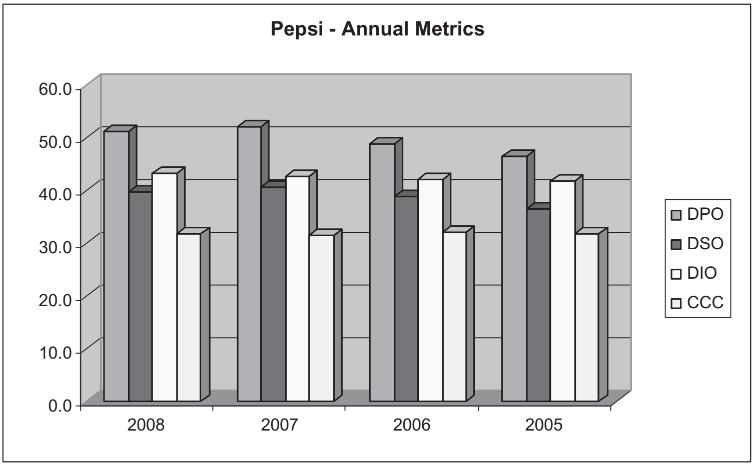
From looking at the components of the Cash Conversion Cycle, Pepsi seems to have its financial back-office in a much more stable state as well as the mix of the component metrics is what one would want to have, reflected in a DPO larger than DSO. This is not the case for DrPepper, which has declining DPO and a rising DSO, indicating a lack of efficiency and structural alignment within the financial back-office processes that affect its working capital. It should be noted, however, that the dramatic change in 2008 can be attributed to DrPepper being spun off from Cadbury-Schweppes as an independent entity.

Return on Sales

Return on sales, also called operating margin, is defined as:

$$\text{ROS} = \text{Operating Income/Net Revenue}$$

ROS is a measure of the efficiency of operations, and it is primarily what separates good management from the rest. Like



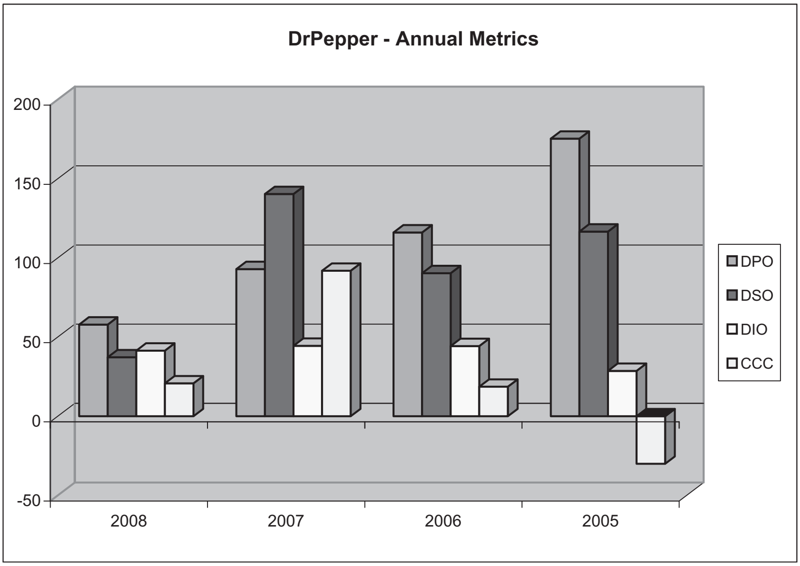


FIGURE 1.4 Cash Conversion Cycle and its Components

any other metric, though, the important factor is the long-term trend this metric follows, not just one measurement at a certain point in time. The best way to make use of ROS and the other metrics mentioned here is to compare them across competitors and with industry averages over a period of time. The key thing about ROS is that it shows the effectiveness of what is being done within the organization for internal-facing purposes that drive the competitive advantage of the business enterprise. Management has perhaps the most control over this key metric than any other. Although this metric has an influence on other metrics that are of more interest to the short-term–focused Wall Street, management cannot easily hide its manipulation. As we saw in the example of Chainsaw Al, some of the destructive tactics employed to improve this metric can be discovered in the public press. There remain, however, other accounting shenanigans that are harder to uncover.

Return on Equity

Return on equity is defined as:

ROE = Net Income/Shareholder Equity

Like all of these ratios, ROE alone is not a determinant of better value of the business. It is meant to indicate the level of return investors are receiving from their investment in the business enterprise as compared to other options they may have for investing their capital. One way to enhance this return is to use more debt in the financial structure. A business that uses greater debt is said to use financial leverage and will have a higher ROE than one with relatively smaller debt levels. However, the debt-intensive business has a higher financial risk and lower financial flexibility. The lower flexibility comes from the fact that interest payment on debt is a short-term liability and therefore affects the liquidity measures—a core concern of the treasury function as part of working capital management. The high-level check on this risk level is conducted by using the *interest coverage ratio*. Different industries, however, have different fundamental requirements for capital and of debt. ROE is best used to compare the performance of companies within the same industry and also for period-over-period performance for the same enterprise.

Return on Assets

Return on assets is defined as:

ROA = Net Income/Total Assets

This is a key ratio that indicates how efficiently management is using the assets to generate profits. Again, a business with a smaller investment in assets will have a higher ROA, and that alone can be misleading in comparing businesses across industries. One key way in which this ratio is manipulated by management for short-term profits is by reducing investment in property, plant, and equipment (PP&E). This reduction in capital assets reduces the denominator in the ROA equation, resulting in a higher measure. Of course, this is not a sustainable state as these physical assets have a finite life and eventually have to be replaced. Again, the short-term focus on profits undermines the enterprise value interests of the shareholders. Let us be clear on one thing, though: There is nothing illegal about management choosing to reduce investment in PP&E. It may even be warranted by certain timing considerations to maximize the opportunity for a cost advantage to the business enterprise. However, we should be concerned when management intentionally and specifically uses tricks to enhance the ROA measure by sacrificing the long-term value of the enterprise. Enron, for example, used a technique whereby certain officers of the company owned separate business entities in which Enron had ownership interest. These entities were used to generate revenue for Enron and owned assets that were not on Enron's balance sheet. Because their profits were included in Enron's income statement to the extent of its ownership interest but the assets were not counted on Enron's balance sheet, Enron's ROA was greatly but misleadingly enhanced.

Return on Invested Capital

Return on invested capital is defined as:

$$\text{ROIC} = \text{Profit after Tax/Invested Capital H}$$

where

Invested Capital = Total Assets − Current Liabilities

ROIC is perhaps the strongest indicator of a business's financial performance as it relates to increasing shareholder value due to its ability to drive stock market multiples of book value. This metric is best used when considered along with economic profit (EP) and revenue growth (if EP is positive). EP is calculated as:

$$\text{EP\%} = \text{ROIC} - \text{WACC}$$

where

WACC = weighted average cost of capital

EP shows the percentage by which the ROIC exceeds the return that could have been earned by investing in Treasury bill plus some equity risk. This is tied to the concept of economic value added (EVA) in corporate finance. EVA is an estimate of true economic profit after making corrective adjustments to generally accepted accounting principle accounting, including deducting the opportunity cost of equity capital. Opportunity cost of equity capital is deducted because in order to correctly evaluate the financial benefit of one investment versus another—in this case investing capital back into the business enterprise or investing it in alternate comparable ventures—the cost of forgoing one or the other must be considered.

All of these measures provide insights into one aspect of profitability or another. However, none of these measures alone gives a complete picture of profitability. Each one alone does not tell us "why" the profitability, high or low, is as it is. DuPont Chemical Company created the DuPont equation to solve this problem. Developed for internal use, this formula has become widely used across all industry segments. The formula is:

$$\underbrace{\frac{\text{Profitability after Tax}}{\text{Equity}}}_{\text{Profitability}} = \underbrace{\frac{\text{Profit after Tax}}{\text{Sales}}}_{\text{Margin}} \times \underbrace{\frac{\text{Sales}}{\text{Total Assets}}}_{\text{Turnover}} \times \underbrace{\frac{\text{Total Assets}}{\text{Equity}}}_{\text{Leverage}}$$

The formula breaks out the components that drive profitability:

- Net profit margin (NPM)
- Assets turnover
- Financial leverage

The reason it is so important to look at profitability in terms of its component parts is that firms in different industry segments have quite different profitability drivers. Even firms within the same industry have different explanations for their profitability ratios. To be effective, management must understand what is driving the profitability of the business.

High-turnover industries, such as retail and grocery stores, typically have very low profit margins but employ high asset turnover, making their cash conversion cycle (CCC) very short. The ROE of such firms may be particularly dependent on performance of the asset turnover metric, and hence it must be studied carefully to determine performance. For example, most retailers consider same-store sales as a key performance indicator (KPI). It shows the level of profits the firm is deriving from existing stores rather than showing improved profits by continually opening new stores.

Other industries, such as heavy machinery manufacturing, may derive their profitability from selling at a higher margin rather than higher sales. The DuPont equation enables analysis to determine which of the elements is dominant in any change of ROE.

Some other sectors, such as financial services, use high leverage to generate acceptable ROE. These businesses generate handsome returns for their equity owners, as was the case with the private equity funds of the late 2000s. These firms, such as the Blackstone Group, became the darlings of Wall Street for this very reason. However, their returns were severely affected as the economic conditions became more challenging and their source of capital dried up. Their high leverage imposed a greater interest expense burden, and earnings suffered. This story is well documented in their stock prices over the past few years.

The ROA ratio developed by DuPont helps evaluate how effectively assets are used. It measures the combined effects of profit margins and asset turnover.

In order to understand the individual ratios and their impact on profitability, one can follow a logic tree as shown in Figure 1.5.

In this diagram, if the profits are being driven by the profit margin, we can look further into its subcomponents to determine where this margin is coming from. How the gross margin compares to the industry average speaks to the efficiency and effectiveness of the procurement and supply chain management function. This tells us whether the firm is paying too much for its COGS and how effective its sourcing strategies are.

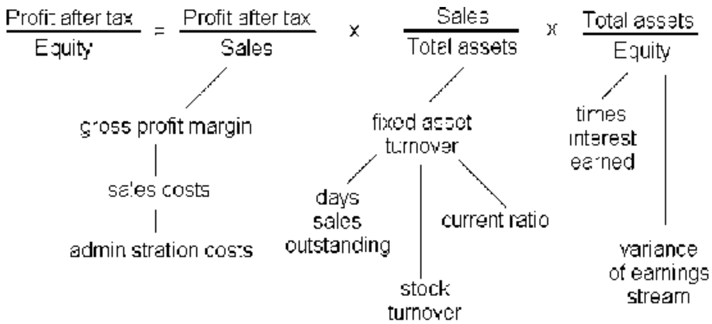


FIGURE 1.5 Profitability Equation Logic Tree

We can also look at the overhead costs, also called sales, general, and administrative (SG&A), and see how the firm compares to the industry average. Keeping in mind that these cost comparisons are being done relative to sales, difference between firms' revenue size is accounted for. The comparison is in terms of a ratio. A low SG&A that supports higher profits over the long haul is a result of well-engineered and optimized back-office support functions including human resources, tax, treasury, accounts payable, accounts receivable, procurement, and information technology, among others. In this regard, it is very important to see if this number is declining or staying constant. The reason for this is related to the common tactic of trimming overhead to prop up profits to make the numbers look favorable. This method is not sustainable for any firm. In the long term, it is the right combination of capabilities and cost that make the difference. Cutting costs to reduce capability for the sake of making the numbers look good is like throwing the baby out with the bathwater. Only a management focused on the short term would take such actions that are not aligned with the core interests of shareholders.

We can also look at asset turnover to see how much it is contributing to profits. Looking at this ratio gives us insight into the efficiency of accounts receivable management via days sales outstanding, inventory management via days inventory outstanding, and the cash conversion cycle. These insights are crucial to understanding the health of the firm and, indirectly, its working capital.

Last, we can look at the leverage component of the profits to see how much it is influencing the results. Here we want to be watchful of a strong number for times interest earned. Although this varies from industry to industry, as a general rule, a high number is desirable—the higher the better. A low number indicates financial risk as the firm is not earning enough to cover the cost of interest on its debt. This is the typical risk a highly leveraged firm takes. In some instances, the debt covenants alone may drive management to take actions that are not in the firm's best long-term interests but are forced on the firm by the debt holders who seek to minimize risk to their investment.

Ultimately, maximizing profitability boils down a very simple idea: A business uses cash to invest capital in creating products or services. It then sells these products or services at a profit and receives payment from its customers. This converts the cash invested into the business back into cash. The greater the velocity, frequency, and magnitude of this cash-to-cash conversion process, the more profitable the business. The magnitude is defined by the profit margin while the velocity and frequency is embodied in the CCC. Optimizing the back office for maximum profitability entails focusing on this CCC.

Liquidity, Growth, and Financial Flexibility

Liquidity, the lifeblood of a business, is a metric that gets ample focus and attention from senior management. The treasury function spends a significant proportion of its resources on managing liquidity. The liquidity level of a business enterprise is a direct result of the general operational characteristics of the business and its strategic decisions in terms of leverage, both operating and financial. What is usually not considered in depth, however, is the influence the core working capital processes of the enterprise have on this crucial metric of an organization's health.

Growth is the objective of every business, small and large. But growth beyond a certain point is not advisable unless certain fundamental financial policy targets are revised and adjustments are made accordingly. The name for this level of growth is sustainable growth rate (SGR).

Financial flexibility is the ability of a business to react to unforeseen events and circumstances in a manner that results in increased advantage and shareholder value. It is a direct result of:

- Debt to equity ratio (D/E)
- Liquidity

A firm with high D/E ratio and low liquidity will not have the financial flexibility to react to adverse situations effectively. However, a firm with a low D/E ratio and ample liquidity will be able to maximize its advantage in the face of unforeseen events. For example, if interest rates increase (an external environment factor), a firm with financial flexibility would be able to maintain its net profit margin by borrowing less to support its operations. It would fund its working capital needs by using the cash generated by its operations. A firm that does not have this financial flexibility will be forced to borrow at a higher interest cost to support its working capital needs, thus sacrificing its net profit margin. The key to achieving this financial flexibility lies in having a fundamental ability to generate ample cash for working capital needs while using financial leverage to generate high returns for equity investors. This in turn implies that the firm's CCC should be short and net profit margin high—both of which ultimately depend on the efficiency and effectiveness of the core business processes. Achieving this financial flexibility requires creating a platform for execution that relieves the chief financial officer (CFO) from the ongoing operational aspects of the financial back office to focus on the value creating aspect of his or her responsibilities. This balancing of the balance sheet to maintain financial flexibility is a constant focus of the office of the CFO. Although using less financial leverage with a lower D/E ratio adversely affects the ROE metric, it does provide a firm with more financial flexibility. The question becomes one of enjoying opportunistic growth through higher financial leverage at times while maintaining a low D/E ratio in the longer term. This is a long-term-focused management decision that uses more financial leverage only in the short term. The result is sustainable profitability and increased shareholder value for the long term.

The discussion on this topic would not be complete without a few words on what is called the *agency problem*—a conflict of interest arising among creditors, shareholders, and management because of differing goals. In the early days of the corporation, shareholders typically were a very small, closely knit group of people. Insofar as the business entity was concerned, their interests and goals were mostly aligned. Management in this case truly "worked" for the shareholders. The agency problem was under control since the management served at the pleasure of the shareholders. This was the case for family-owned businesses in the past and remains the same for privately held corporations of all sizes today. As times changed and the number of investors grew, the control structure of the corporation changed significantly. As a result, today things are vastly different. The number of shareholders is very large for the typical public company. Although the board of directors theoretically represents the shareholders, in practice this is not always true. The board members of most of the firms are themselves officers of other firms. This creates a climate in which doing the right thing for shareholders is not always clearly defined or easy. Shareholders still have a say, albeit it is a reactive one. When poor management decisions result in a drop in the stock price, shareholders may sell their shares, usually at a loss. This certainly is not sufficient control for shareholders, whose only remedy is limited and after the fact and results in incurring a loss.

Warren Buffett is credited as being the most successful "stock market investor" in history. However, this is not accurate. His success, through Berkshire Hathaway, is a direct result of the fact that he buys most companies either entirely or secures a controlling interest in them. The nature of his "shareholding" is quite different from the average shareholder since the company officers are his employees. Just as in the old days, there is no agency problem.

No doubt this issue is a complex one. By no means am I suggesting that all of those who are engaged in managing public companies are out to enrich themselves at the expense of shareholders. However, facts and historical evidence (Enron, WorldCom, Tyco, Global Crossing, and many others) bear out the fact that ample opportunity exists for managers of public companies to short-change shareholders. And if the purpose of a business enterprise is to maximize shareholder value, then what does the agency problem mean for the reason of existence of a business?

Japanese companies can be used as a great lesson in this regard. Toyota, for example, has remained at the top of its industry through good economic times and bad. A key to its success has been the fact that when something adverse occurs that requires cost cutting, top executives take a significant cut in pay. Given that the Japanese executives are not nearly as well compensated as their western counterparts, the cut in compensation is material. The effect is twofold: It puts the pain where it belongs, and it fosters loyalty at the lower levels of the organization during turbulent times when morale problems are a serious concern. When the loyal and motivated human resources of the company rally behind management they trust and respect, it is no wonder the firm pulls through turbulent times.

It is interesting to note that 78% of companies interviewed for a University of Washington study admitted to artificially smoothing earnings and sacrificing shareholder value in order to meet or beat Wall Street expectations. Fifty-five percent also said they would avoid initiating a project with a very positive net present value if it meant falling short of the current quarter's consensus on earnings.[3] This phenomenon should be alarming to all of us engaged in the business of managing, investing in, and working for public corporations.

When corporate scandals started to hit the headlines in the United States and more recently Europe, legislators' response was swift and efficient. Amid a flurry of reviews, consultations, and debates about business ethics, a whole new set of legislation was introduced in an attempt to restore faith in capital markets. On both sides of the Atlantic, much of this effort was focused on regulatory and corporate governance issues. This was hardly surprising, considering the nature and magnitude of the problems. In addition, it is unlikely that the focus on corporate governance and regulation is going to wane anytime soon, despite the inevitable industry backlash. The reforms continue and, for many, the effects of Sarbanes-Oxley in the United States and the new Combined Code in the United Kingdom are starting to be felt. There is a danger, however, that this attempt to improve the way in which companies are regulated and governed will detract from the basics of value creation. Good corporate governance may be a necessary prerequisite but will not by itself lead to superior performance—which is, after all, what investors want and expect in return for their money.

Case Study

A $1 billion company in the healthcare industry needed to grow its operations in order to gain deeper penetration and brand recognition in the marketplace. The board engaged a consulting firm that specialized in benchmarking and analyzing the overall performance of the firm to provide fresh insights into creating a road map for transformation. The findings from benchmarking and process analysis revealed that the inefficiency of its back-office processes in general and the financial back office in particular were creating a drag on its margins. This weakness in the margins was affecting the company's ability to expand as it wanted and could be remedied through a realignment of the processes with the corporate objectives.

The fundamental issue was the lack of strong governance and weak controls within the core processes. This situation was further worsened by the highly manual nature of the processes. As a result, the organization was going through a high turnover in personnel, which not only impacted its operations in terms of the quality of care it could provide to its patients but also morale issues for its own personnel. Management was focused on keeping the work flowing through long shifts and extensive manual checking of reports to detect problems. Usually this checking could not be done until after the fact, leading to issues in patient care that impacted the company's brand image.

Turning around the situation required an investment in its core processes. Taking a fresh approach following the recommendations of the outside firm, senior management stepped back from focusing on the next few quarterly results and devoted their energies and resources to making fundamental improvements in operational and back-office processes. The improvements combined changes in its governance structure and mechanisms, policies, and procedures and in operational and financial processes.

After an 18-month effort that engaged its personnel at all levels, the organization emerged as a superb example of a business entity that was built for "profitability," not just profits. The quality of patient care was high, personnel morale was improved significantly, employee turnover and absenteeism were the lowest it had ever been, operating costs were lower and predictable, and management was able to confidently project operational results. This change enabled the company to raise the capital it needed on favorable terms to expand into the marketplace.

Conclusion

Changing a focus from profits to profitability is a critical first step toward making an organization "Built to Last."[4] The fortunes at DuPont and General Electric were not built by management focused on the short term. These giants of the American business landscape have lasted a long time and seen the ups and downs that come with such longevity. Their operating models and supporting processes leverage a platform for execution that is geared toward fundamental profitability, not merely profits.

It may seem like a trivial matter that is obvious to many, but thinking about the long term and making decisions on that basis is not something that many companies appear to commit to. It takes courage to excel and faith in the capabilities of the organization to ride out the storms of the marketplace. Of course, this means having built the capabilities needed to weather these storms in the first place. Doing this requires investing in those core capabilities. This act of investment itself is evidence of a long-term focus. It is not the same as using cost cutting as the primary tool to improve earnings during a downturn. Rather, it is an approach that seeks to minimize the drag on revenues at all times through an optimized and streamlined platform for execution.

Notes

1. Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).
2. Larry Bossidy and Ram Charan, *Execution: The Discipline of Getting Things Done* (New York: Crown Business, 2002).
3. John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting," January 11, 2005, www.faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W73_The_economic_implications.pdf.
4. Jim Collins and Jerry I. Porras, *Built to Last: Successful Habits of Visionary Companies* (New York: Harper Business, 2004).