

# THE QUARTERLY

JULY, 2004

Welcome to the inaugural issue of *The Quarterly*, a periodic report of news and findings related to improving profitability. We hope that you find value from this publication; please contact us with your comments and suggestions.

## RECENT NEWS

*In his article "What Makes an Effective Executive" (Harvard Business Review, June, 2004) Peter F. Drucker writes "Good executives focus on opportunities rather than problems. Problems have to be taken care of, of course; ... But problem solving, however necessary, does not produce results. It prevents damage. Exploiting opportunities produces results."*

*As we describe in this issue of "The Quarterly," many companies have created blinders that hide opportunities, and thereby penalize performance, often substantially.*

*Executives can energize their companies' performance by removing these blinders, and building opportunity-focused decision-making processes.*

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## WE HAVE UPDATED OUR METHODOLOGY AND THE OPPORTUNITY BROWSER®

- *New functionality compares client's business unit and manager performance measures with opportunity-based measurements*
- *New functionality provides opportunity profiles at all levels within client organizations*

## THE BLINDERS THAT UNDERMINE PERFORMANCE

Over the past five years we have worked with clients in several industries to assess performance potential and identify best opportunities for profit improvement. Client executives have used the comprehensive and systematic "opportunity profiles" we have developed to identify opportunities to improve their bottom lines substantially, by 5% to 10% through tactical action, and by 10% and more through strategic action.

While our work has been directed at profit improvement, our findings have led executives to conclude that they needed to make changes in fundamental management processes, such as goal-setting and incentive compensation. In this document we describe the background of this discovery, its implications for effective management, and the steps we are taking in response.

### A curious result: Opportunities "hiding in plain sight"

Though details of client engagements have differed, our projects have had one striking characteristic in common – clients concluded that the profit improvement opportunities we identified were, in retrospect, glaringly obvious. As one client put it, "We have not been achieving our potential. Opportunities for profitable growth have been hiding in plain sight."

Our discovery of the obvious produced results ranging from mild embarrassment ("I cannot believe we missed this.") to outright disbelief ("This cannot be true, or our market research group would have found it."). In each case, we have been able to demonstrate that our conclusions were valid, and have traced clients' inability to find "obvious" opportunities to one fundamental issue.

### Self-imposed management blinders hide opportunities

We have found that many companies fail to identify "obvious" opportunities because their understanding of performance is incomplete – rich in detail, but incomplete, undermined by "management blinders" that hide opportunities. These blinders are largely self-created, an unintended consequence of the decisions executives make about what to measure, how to measure it, what targets to set, how to assign responsibility, how to encourage/facilitate desirable action, and how to evaluate performance.

Because opportunities don't always coincide with performance that falls short of target, they often go un-noticed when management policies, processes and systems focus too much on hitting targets, and not enough on achieving potential. Indeed, our clients have been particularly surprised to find that some of their best opportunities were in business units and customer relationships that already generated very strong earnings.

### Blinders undermine essential management practices

These blinders have a larger impact than just hiding opportunities. They also limit the effectiveness of fundamental management processes, such as: goal-setting, incentive compensation, resource deployment, management development, and investment analysis.

We found a very telling example of this in a recent engagement. One key tool that our client used to guide and motivate action was a manager ranking process. Using a set of financial and operational measures, the company force-ranked all managers. Those in the top quartile received substantial bonuses and good advancement opportunities, while

those in the bottom quartile were counseled that their compensation and careers required quick performance improvement.

But this client's ranking process substantially distorted executives' assessments of managerial success. As illustrated below, the rankings that the client used for judging managers bore little resemblance to rankings that reflected managers' successes in achieving the potential of their units.

**Consistency of Client's Performance Measurement Rankings and Opportunity-Based Rankings**

		Manager rankings by existing performance measurement system			
		Top quartile	2nd quartile	3rd quartile	4th quartile
Manager rankings based on Opportunity	Top quartile	7%	8%	6%	4%
	2nd quartile	7%	6%	6%	6%
	3rd quartile	8%	5%	6%	5%
	4th quartile	4%	6%	7%	9%

- Manager rankings are consistent
- Manager rankings differ by 1 quartile
- Manager rankings differ by 2 or 3 quartiles

Some managers that the company had ranked most highly were, in fact, among the company's least successful in achieving their potential. (Note the 4% in the bottom left hand corner of the table above.) While they were paid well, and often promoted, they were not particularly effective in capturing the opportunities offered by their markets. In the client executive's words, "Some of our Platinum Performers have been leaving an awful lot of money on the table. We have not been asking them to do enough."

Meanwhile, some of the managers who had been particularly successful in achieving their potential were assessed, by the company's ranking system, as being weak performers. (Note the 4% in the top right hand corner of the table above.) The client was able to identify several such managers who had been counseled out of the company, having failed to achieve performance goals that, in retrospect, looked unachievable.

**Blinders inhibit action**

Blinders do even more serious damage than hiding opportunities and undermining the effectiveness of fundamental management processes. They also inhibit action.

We recently completed an engagement with a client that had built a strong sales culture throughout its retail network, and had been extraordinarily successful in captur-

ing share in most of the markets it served. But the company's performance evaluation systems and goal setting processes were so focused on sales that line managers gave little consideration to other earnings drivers, such as profit margins and customer loyalty, for example. Actions guided by these blinders penalized the company's bottom line – encouraging volume but not always value, and discouraging investment in the maintenance and enrichment of customer relationships.

Many line managers had recognized the blinders that biased the company's incentive compensation programs. They understood that their successes, measured by their compensation, sometimes required actions that were inconsistent with the company's performance objectives. But they felt little incentive to address such issues publicly. Considering blinders to be unavoidable and largely unchallengeable parts of the decision-making landscape, they worked to maximize their compensation through what several managers had termed "more of the same but better" decision-making. So, even when they recognized "hidden opportunities," they chose not to pursue those that would not boost their compensation.

**We now assess performance evaluation processes**

As we have learned more about the ways in which companies create and institutionalize blinders that undermine performance, we have expanded our solution to address the issue explicitly. We now incorporate client performance evaluation information (such as profit measures and incentive metrics) into the Opportunity Browser®, and compare it with opportunity-based performance assessments. We do this at a summary level, as illustrated in the table above, as well as in opportunity profiles for individual units throughout each client's organizational hierarchy.

In the management presentation with which we conclude each of our engagements we now present findings that include a profile of performance improvement opportunities, and an assessment of how well performance evaluation processes reflect managers' successes in capturing their best opportunities. We also recommend actions that clients can improve their performance, extend and enrich their opportunity profiles, and improve the effectiveness of goal-setting and compensation processes.

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