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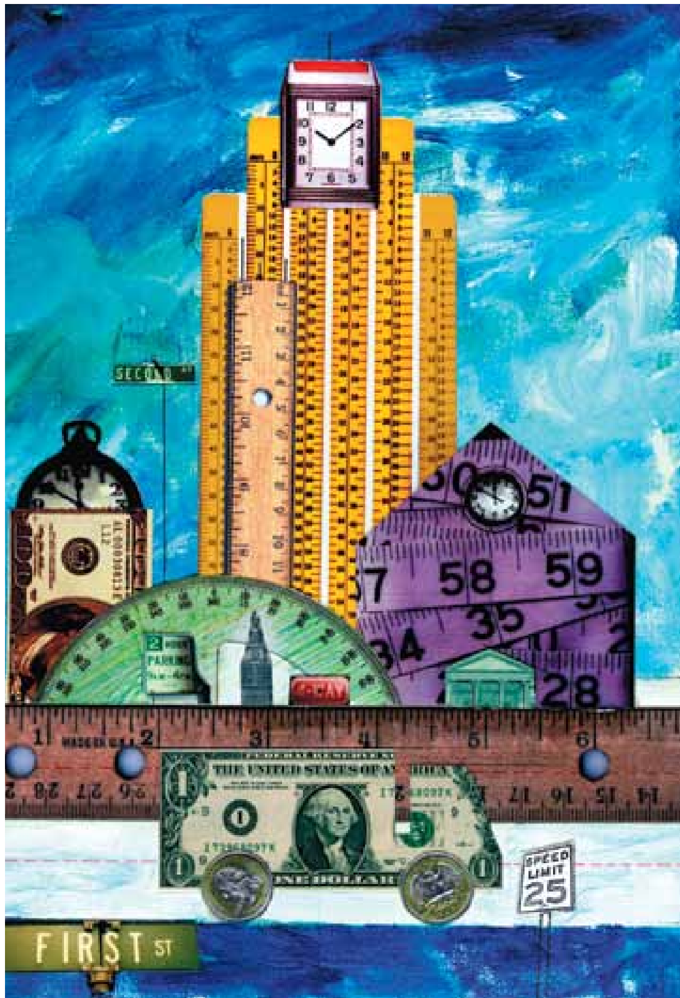
THE case against THE business case



FOCUSING ON FINANCIALS CAN BE BAD FOR BUSINESS.

BY VADIM LIBERMAN

WHAT DOES IT MEAN TO SAY SOMETHING IS GOOD FOR BUSINESS? Imagine you're a diversity executive. You're used to answering that question before it's even asked—unless, perhaps, your CFO is the one doing the asking. So you explain to her that diversity impacts employee engagement, which motivates workers, spurring them to collaborate on new ideas for—

Wait—what's with the weird look on the CFO's face?

You know the answer. It's not that she doubts you. It's that she wants to know not *why* but *how*

diversity is good for business. Engagement and motivation data are nice, but the main numbers in which she's interested follow dollar signs. In other words, she insists you make a business case.

You need not be a director of diversity—or marketing or product development or social media or any specific division—to find yourself in the daunting position of having to use Excel and PowerPoint to justify your activities. And it's not only accounting heads whipping out their calculators. Making and judging business cases is increasingly part of all our jobs, so much so that the process is almost meaningless: "business case" is nowadays so often invoked, so broadly applied, that we've stripped the term of any significance. If something—anything—boosts customer satisfaction, sales, productivity, media impressions, worker retention, you name it, then it satisfies a business case. Here's what's unsatisfying: When there are as many versions of as there are people making business cases, the joke's on us.

Let's be real. At some deeper level, when we say "business case," we really mean a *financial*, *measureable* rationale. Increasingly, corporations agree. Similar to what happens regarding executive pay, when times are good, fewer people complain, but the moment the economy wobbles, out come the magnifying lenses. These days, searing scrutiny is forcing everyone to move beyond simply stating that efforts are somehow, someway, somewhere, somewhat good for the bottom line. Now you have to prove it.

This article isn't titled "How to Make a Business Case"—calculating ROI, revenue, profits, losses, etc. You have accountants to write that story. Rather, it's about pondering the situational importance of applying a cost-benefit analysis to making financial cost-benefit analyses. And so the real questions become: How do you determine which initiatives should demand greater financial focus? Should any require less? And what if you cannot, or should not, or do not want to prove pecuniary benefits? What then?

STARTING LINE

Wouldn't it be great to squeeze the answers neatly into a graph?

We're manic for metrics. They help us make sense of the world, even when they don't make sense themselves. "We see numbers as 'hard' outputs: objective, reliable, repeatable, verifiable," wrote Susan Webber in "Management's Great Addiction" in this magazine's May/June 2006 issue. "But most management data is softer than, say, your company's stock price at the close of trading. Even if we understand those limitations intellectually, we somehow lose that perspective when we wrestle with figures."

Webber, a management consultant, had in mind metrics in general, but when she referenced stock price, intentionally or not, she tapped into our

collective belief that we don't measure all measures equally. We get high off of the apparent definiteness and definitiveness of financials in ways that we do not off of other data. We forget that numerals don't actually speak—people do. It's someone's (sometimes our own) interpretation of numbers that stirs head nods or eye rolls.

Nonetheless, money remains the international language of business. The trouble is, sometimes we get lost in translation of financial data into a business case.

Speaking of, what is your business case for office supplies? No, this isn't satire—you're not reading *The Onion*. Legal pads aren't free, so your company must have held executive-committee meetings to validate their procurement, right? Ernst & Young presumably computed expected ROIs, and after months of deep reflection, you conceived a solid business case for your walk over to Office Depot.

If this seems absurd, the point is not: Somewhere between purchasing a paperclip and opening an overseas plant, cost-benefit reviews become important. But where?

"Oftentimes, the money is already sitting in the budget. It's not something that a manager has to ask for, so he isn't forced to make a business case," explains Mike Bourne, director of the Centre for Business Performance at Cranfield University in England and co-author of the *Handbook of Corporate Performance Management*. For most sizeable capital expenses, however, large corporations commonly draw a cost-based line—with pens and pencils that obviously fall below that line. What's mainly relevant is not where but that companies do this to avoid plundering resources that could exceed those actually related to the investment. To use an extreme example: "We've all been in a situation where someone in Accounting goes berserk over a cab fare or because you had an extra French fry," says David Larcker, the James Irvin Miller Professor of Accounting at Stanford's Graduate School of Business. "Going back and forth about business cases for such things is not worth it. Just pay it. Otherwise, you'll piss off people." Worse, you may waste time and effort struggling to make business cases for business cases.

Choosing a fiscal threshold is the easiest decision regarding when to make a business case. So easy, in fact, that it deceives us by presupposing the answer to a central, underpinning question: Can we subject everything to a business case?

"Everything can be valued financially," claims Bourne. To a degree, that's true. You can slap a price tag on anything. Training programs cost this; IT equipment costs that. But knowing the price of everything and the value of nothing risks stumbling to a point of no returns, where a marketing campaign that costs $1 million might be worth no more than $1. To mull over whether something will actually merit its cost, you must consider how—if—you'll eventually evaluate financial results.

CAUSE AND NO EFFECT

While a proxy statement *shows* the financial health of an organization, it does not *explain* it. "Accounting is really great at telling you if you made money," Larcker says, "but it's not so great at saying: Here's the procedure or process that made you that money." Actually, it may not tell you whether an activity generated income at all!

Take corporate philanthropy. Companies gave over $15 billion to causes in 2010, according to trackers at the GivingUSA Foundation, perhaps due to a positive association between social and financial performance. But does more giving lead to higher profits or vice versa? Or neither?

The point is that no one should confuse an association with causation, especially for non-capital investments such as advertising, marketing, sustainability, diversity, public relations, and anything that reallocates people's time and effort. A variety of variables blocks a direct causal route from A to B, or more like a twisting road to Z where an entire alphabet of suppositions looms to bump you off. The smog especially thickens with long-term-evaluation timelines. For instance, while Macy's can track product performance quarterly, Boeing may take years to assess its investments. By then, innumerable variables can litter the path to clear correlations.

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EVEN IF YOU COULD SOMEHOW DEMONSTRATE BASIC CAUSALITY, YOU'D STILL BE UNLIKELY TO SHOW THE EXTENT TO WHICH A SPECIFIC ACTIVITY IMPACTED FINANCIAL PERFORMANCE.

numbers, which become purely subjective based on underlying assumptions," explains J.P. Eggers, assistant professor of management and operations at NYU's Stern School of Business. So the next time a consultant beguiles you with wild algorithms showing a social-media campaign's profits, *es como leer Español cuando no sabe el idioma. Puede leer las palabras pero no reconsceras*

el significado. It's like reading Spanish when you don't know the language. You can sound out the words, but you won't comprehend their meaning.

"At FedEx, we don't pretend that we figured out causal links, because there are no clean sets of linkages," says Rebecca Yeung, the company's director of enterprise quality. The shipping giant is not alone. According to Larcker, fewer than 30 percent of companies have developed models making causal connections to long-term economic performance. Even if you could somehow demonstrate basic causality, you'd still be unlikely to show the *extent* to which a specific activity impacted financial performance. For example, can you convincingly argue that a few extra hours of customer-service training added a certain amount to the bottom line?

Some years back, Larcker, along with Wharton accounting professor Christopher Ittner, studied a telecommunications company that sought to achieve a 100 percent customer-satisfaction rate. However, the organization didn't attempt to find out whether a customer's level of satisfaction correlated with profits that customer generated. In fact, such a relationship existed, but only to a degree: Customers who were 100 percent satisfied spent no more money than those who were only 80 percent satisfied.

Hold on, you might be thinking. Doesn't this prove that you *can* link nonfinancial to financial performance?

Not exactly. You don't invest in customer satisfaction. You invest in training or technology or workers or any number of factors that you hope will bolster customer satisfaction. The relationship that matters most is not between a customer-service score and profits but between the actual investment and revenues. Sure, other factors being equal, you can use a nonfinancial measure to fill the gap—except that nothing is ever equal. The road to revenue blurs with ever-changing variables, the impacts of which smear across your accounting numbers.

Who cares, right? You made money. Yes, but just because business isn't a hard science doesn't mean it should be a casino. Rolling your performance results onto a craps table won't likely increase your odds of future success. Drilling down to identify the sources of your profits will. Moreover, you're still left with the dilemma of deciding among investments in projects that increase customer service, employee engagement, marketing, and other intangibles.

"For a company our size," explains FedEx's Yeung, "it's difficult to isolate one thing that is incremental to revenue because every single day, there are many things happening that affect business. We have so many functional areas that it's hard for any one of them to claim they did something that directly led to revenue."

Messier still, if you're unable to make a single tight fiscal argument for one initiative, how do you compare multiple murky financial cases? For example, dollars devoted to developing a new

product may yield high returns, but higher than the same amount spent on, say, customer-service training? As your decision-making basket grows heavier with more possible investments, each with its own unique assumptions, a look inside it reveals not just apples and oranges but many other fruits, vegetables, and legumes that makes comparing them a sour burden.

BEYOND FINANCIALS

All that arithmetic can knock you down for the count—if you attempt to count anything in the first place. Many managers do not. Some are too lazy to make business cases. Others may have more practical grounds not to. A study by the consultancy ESI International bears out that fewer than half of surveyed executives track the impact, financial or otherwise, of their training and learning programs, commonly citing reasons such as lack of resources and confusion about what to measure. A majority of those who don't gauge results claim that they're not asked to. (Notably, almost 20 percent of managers who don't measure business impact admit it's because—get ready for it—they are worried about the outcomes.) Furthermore, of those who assess any type of performance, less than 40 percent evaluate ROI or revenue. At FedEx, explains Yeung, "we measure everything we can. When we don't measure something, it's because it's not obvious *how* to." Is everyone else just calculating the incalculable?

So what do you measure? You monitor what you can—namely, nonfinancial indicators such as quality, productivity, engagement, retention, and satisfaction. Tracking intangibles not on a balance sheet illuminates a more balanced view of corporate well-being, or so the thinking goes. "Sometimes you cannot use ROI to justify something, so you take a multifaceted approach," Yeung explains. "We invest in technology infrastructure that does not generate direct revenue, but it enables us to provide an outstanding customer experience, which in turn leads to financial payout."

"Not everything requires a cash-flow analysis," Eggers adds. "For example, an attempt to do that for media relations won't be helpful, so you say, Look, having a strong PR presence allows us to mitigate potential reputational damage and risk, increases our public awareness, and improves public image—and in the end, these things are good for the company's bottom line."

Indeed, such correlations are obvious. Maybe. Selecting the right staff, which drives employee satisfaction, which drives employee-added value, which drives customer satisfaction, which drives customer buying behavior, which drives sustained profitability, finally drives shareholder value. This model, at least, seemed self-evident to the fast-food chain that developed it, according to Larcker. Unfortunately, for various reasons, the numerous assumptions connecting the dots fell short. Not nearly so linear, the real world failed to fit onto a PowerPoint slide.

Meanwhile, applying a media-impressions metric to one endeavor and a customer-experience score to another propels us to another problem similar to that of employing financials to compare activities—only this time, how do you use nonfinancials to do so?

Maybe you don't. It's not only that weighing customer-service and employee-engagement values may be pitting apples against oranges. *The projects themselves are not all apples*. Except *don't* is not synonymous with *can't*. It's a cruel paradox to argue that you must do something you feel you can't, but ultimately, you have no choice but to compare the incomparable. Tragically, the very nature of business lies in allocating limited resources. The problem with using nonfinancial numbers to do so: Their key disadvantage can mutate into an advantage for some. That is, the vaguer the measure, the more manipulable. For example, at an auto-components manufacturer that Larcker and Ittner studied, managers met quality targets by accepting flaws in parts that they would have previously rejected.

Even good intentions can spawn bad outcomes: By lowering a product's price, a company may improve customer-satisfaction and market-share ratings—and hurt profits. (But hey, who knows? It's not as if you can absolutely prove such links anyway.) Likewise, focusing on nonfinancials in the decision-making stage can help managers gain approval for their projects or kill those of others.

IS EVERYONE ELSE JUST CALCULATING THE INCALCULABLE?

"These kind of numbers are a way to avoid making a financial case," Bourne explains. "Instead, they should be conversation starters, as long as management sees them for what they are."

BUT NOT TOO FAR BEYOND FINANCIALS

What are they exactly? Primarily, they are what financial numbers are not—vulnerable pansies that managers can bully. Accounting digits stand up better to attempts at manipulation. And whereas there is a mass of means to compute and report customer satisfaction, productivity, brand awareness, and other nonfinancial data, financial figures lack such fluidity. In fact, various departments at a company often measure the same indicator differently. At least in financial accounting, there are more widely accepted rules and standards. Sure, creative accounting is practically a practice unto itself, but to argue that we elevate money metrics above others simply because they're less susceptible to tinkering misses their main appeal.

TURNING FINANCIALS INTO A SWORD THAT SLAYS NUMEROUS ACTIVITIES RISKS BUTCHERING RISK ITSELF, WHICH CAN RUIN INNOVATION AND CREATIVITY.

Financials are the sole objective standard that we can apply across every project, function, and person, the common denominator to compare different initiatives, from different departments, from different companies. Plus, we may not grasp the nebulousness of an extra employee-engagement survey percentage point, but we certainly know what a dollar looks like.

Besides, tossing in too many metrics risks what Larcker calls "measurement disintegration," in which an overabundance of marginal, insignificant, or irrelevant assessments dilutes the effect of the measurement process. A leading home-finance company that Larcker and Ittner studied suffered paralysis by analysis after instituting an "executive dashboard" that eventually ballooned to tracking nearly three hundred measures. Larcker also points to a bank that adopted multiple accounting and nonfinancial measures. As a result, the time per quarter that area directors began spending on evaluation jumped from less than one day to six days. Eventually, the company reverted to fewer, money-based measures.

Still, though financials numbers are more objective and understandable than their nonfinancial counterparts, the wielding of them may be anything but. In fact, by acknowledging the subjectivity of nonfinancials, we already view them skeptically. "Everyone recognizes that the nonfinancial side is subject to interpretation and beliefs, but there's a blind belief that when something is on an Excel sheet and produces a positive value, it must be right," Eggers says. Consequently, instead of fiddling with nonfinancial metrics, managers may find it more expedient to fling accounting numbers to red- or greenlight projects.

For example, when an initiative related to social responsibility doesn't show profits on a spreadsheet, a focus on financials can easily squash it. We can say the same for many initiatives that aren't clearly financially quantifiable. But turning financials into a sword that slays numerous activities risks butchering risk itself, which can ruin innovation and creativity. The reverse is also true. Suppose you base a strong business case on cost savings to move your call center from Maine to Manila. Sure, lower prices for labor and rent will improve your financial numbers, but if the relocation spoils customer satisfaction, intra-organizational communication, and a host of other intangibles, you may not discover the move's true

cost until it's too late. "Just because something looks good on paper," Yeung says, "doesn't mean it will look good in real life."

BAD AND WORSE

By now, the ping-pong between financials and their weaker complements must feel like when one door closes, another slams in your face. Unfortunately, there's no portal that opens to an ideal measurement, especially given that at least 70 percent of companies employ metrics that lack statistical validity and reliability, Larcker estimates. Yes, financial may trump nonfinancial data, but now we're just comparing bad and worse.

Ultimately, hard numbers matter more. Just think: What if financial and nonfinancial performances diverge? "Usually, this doesn't happen," Bourne says. "When it does, it's because we're only looking at the short term, but of course, if a company sees this happening over a period of time, then financials should trump nonfinancial performance." Obviously. You can brag all you want about winning brand-recognition, customer-satisfaction, and employee-retention scores, but unless they lead to major revenue, you're losing the game.

In the end, there's probably something wrong with either the activities or the measurements if you're hitting your nonfinancial targets but not your financial ones. The main reason we measure intangibles to begin with is not because we want to but because we can (or think we can); they serve as proxies for the numbers that really matter.

So where does that leave us? If you're seeking a single measurement to escape the metrics maze, you won't find it here. "Using a standard template, financial or otherwise, for quantifying anything is problematic because the decisions we make are not comparable in clear ways. It's a dangerous path to go down," Eggers says. Likewise, there's no suggestion to segregate corporate activities into camps—this project requires a focus on financials, this one does not—based on frequently unreliable data.

In fact, there are situations when you may want to ditch the data altogether—that is, avoid making a business case not because you cannot but because you think you should not. You might argue against financially trying to justify philanthropy, sustainability, safety, or other perceived social goods or standards of doing business. "There are certain instances in which you may decide no financial arithmetic needs to be done," Larcker says. "You may decide this is how we're going to treat people. This is what we stand for. If you don't like it, don't work for us, and don't buy our stock."

FedEx, for example, does not try to tie dollars to diversity, which is "part of our belief system and culture," Yeung explains. "We don't bring in consultants to justify our investments in diversity. If you try to make a measurable business case for it, you won't be able to, defeating the whole purpose of diversity."

In other instances, a ticking clock may leave no time to account for accounting. Potential opportunities can quickly total zero by the time you finish all your adding, subtracting, multiplying, and dividing, at the other end of the equation.

Even without such constraints, if business were as simple as surrendering all the work to numbers, we wouldn't need managers. And so, the real link between an activity and revenue is not nonfinancial performance but people. More specifically, it all boils down to what business has been and always will be about: you, the manager. "Not everything is a scientific decision," Yeung says. "A lot of times, good instinct, experience, and judgment must come into play." Thus, you shouldn't hurl figures around when making a business case or evaluating results as if the digits tell the whole story—because, as mentioned before, numbers do not speak. Nor do they make decisions. You do. There's a certain illogic of blaming poor data when initiatives fail and accepting lavish praise when they succeed. n the end, the responsibility lies with you.

Perhaps Larcker offers the best advice: "You can't quantify everything down to the nit," he points out. "You've just got to acknowledge key assumptions and get as much evidence as possible. You won't have all the information, but ultimately, you'll be able to better decide if something makes sense." If this still seems like insufficient guidance, you can always hire consultants to help the process along—if you can make the business case for them. ■

IN THE END, THERE'S PROBABLY SOMETHING WRONG WITH EITHER THE ACTIVITIES OR THE MEASUREMENTS IF YOU'RE HITTING YOUR NONFINANCIAL TARGETS BUT NOT YOUR FINANCIAL ONES.