

Tulip FEVER



Business incompetence can bloom even at the most prestigious corporation. Business schools can help students identify the syndromes that indicate a company is offering fertile ground for trouble.

A few years ago, a top Harvard professor addressed a gathering of business school deans in The Netherlands. He noted that Harvard's top MBAs were no longer joining Wall Street but setting up dot-com companies and starting to make their fortunes while still at college. Partway through the talk, he asked the audience, "What do you think?"

"Tulips," someone responded. The audience laughed, and the chairperson of the event explained the tulip mania frenzy that engulfed Holland between 1634 and 1637. So desperate were investors for the new bulbs that they were spending thousands of dollars on tulip futures—on items that did not actually exist. The parallels between that situation and the dot-com mania were obvious.

by John Saunders

illustrations by David Clark

Investing in nonexistent products and blindly following an exciting new market are far from being the only mistakes business owners make. Recently, I was driving to a dot-com company with an executive from the venture capital firm 3i. The dot-com was interested in raising funds from 3i. I asked the 3i exec what signs she looked for to indicate that a company might *not* be worth funding. She said, "I look for all the signs that indicate people are playing at business, not working at it. A flashy building with ego-sized offices and arty communal areas. Excessive executive perks, manicured gardens, and flags—loads of flags."

We turned off the road into the driveway of the company chasing 3i's money. Through the trees we could see the corporate HQ in a beautifully restored country house with several exotic cars parked in the driveway. "And there are the flags!" exclaimed my passenger. "A whole United Nations of them."

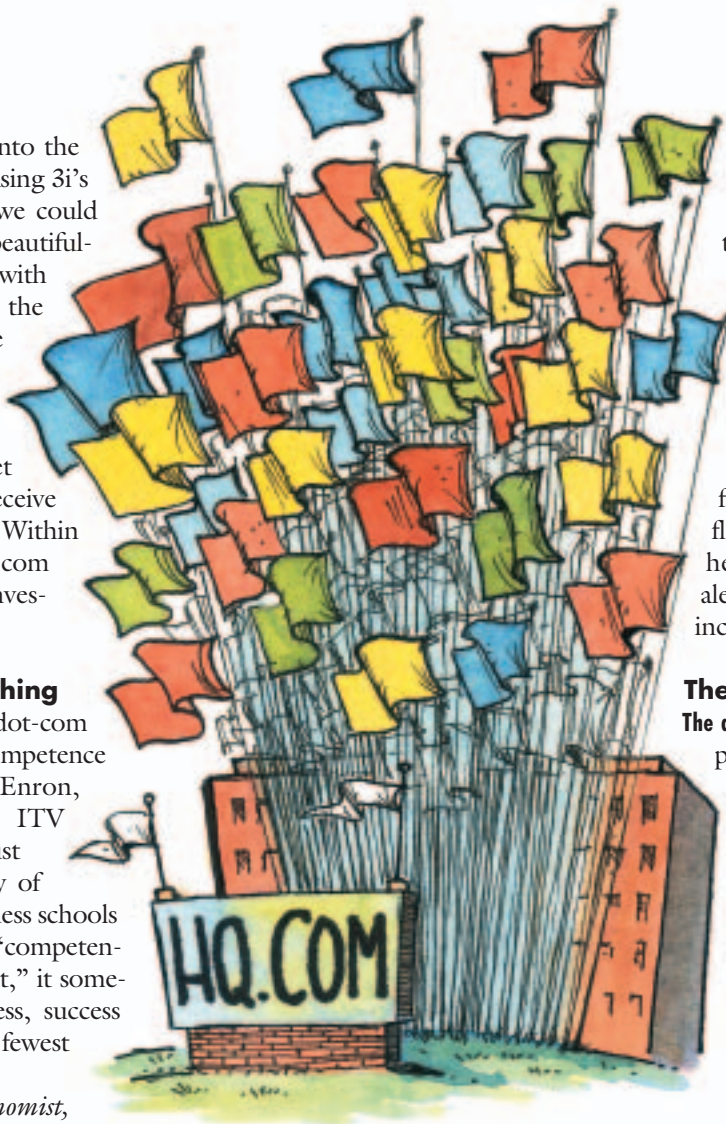
The company did not get 3i's money, but it did receive funding from other sources. Within months, it went from dot-com to dot-bomb, taking its investors' money with it.

Incompetence Is Flourishing

Like tulip mania and the dot-com bust show us, business incompetence is in perennial bloom. Enron, WorldCom, Allied Irish, ITV Digital, and Consignia are just the latest in a tragic history of business failures. While business schools concentrate on developing "competencies" and "doing things right," it sometimes seems that, in business, success also is based on making the fewest catastrophic mistakes.

In an article in *The Economist*, Lloyds TSB was unusually humble in explaining how it became the world's most highly valued retail bank. Lloyds TSB floated to the top, representatives said, because everyone else was making silly mistakes, diversifying overseas and into lots of businesses that Lloyds did not understand. It turned out that the other banks did not understand the new businesses either. They lost their shirts, jobs, bonuses, and tower blocks by following each other into a series of copycat international misadventures.

What makes businesses blow it? Lloyds TSB's competitors and the dot-com bomber both give some clues. It is not lack of competence, because both concerns were full of highly trained and motivated staff. It is not lack of strategy—they had that in abundance. Business incompetence is caused by a bundle of circumstances that in themselves are innocuous but that—given the wrong time, the wrong market, and the wrong people—can combine to cause catastrophic failure.



Business incompetence is not just a random alignment of unfortunate circumstances; there are patterns and clues to follow. It is important to understand what conditions are precursors of business incompetence—and how we can teach business school students to recognize and avoid them in their own careers. The following syndromes, like the flags waving before a corporate headquarters building, should alert anyone to the possibility of incompetence in bloom.

The Signs of Incompetence

The delusion of omnipotence: Some companies fail when they become institutions. They become less of a business and more of a national treasure. Two British retailers that fell foul of such delusion were Sainsbury's supermarket chain and Marks and Spencer. Both were market leaders with a comfortable, noncommercial feel about them. The staff cared about their customers, and the respectable middle class flocked to them.

Yet, both became more like state institutions than stores. Both had huge central London headquarters more befitting a government department than a retailer. Moreover, the way they retailed demanded huge operations. They focused on their own high-end brands, disdained sales promotions, and—in the case of M&S—refused to accept any credit cards but their own. Eventually, Sainsbury's arch rival stole its No. 1 slot as Britain's lead grocer, and M&S lost ground to marketers who attacked it from both the high end and the discount end. Neither retailer realized that it had to adapt its own way of doing business to the way business was currently being done.

Monumental mistakes: Corporate executives are also in trouble when they fail to concentrate on the business itself and instead focus on outward symbols of prestige, such as huge buildings. Yet deposed British Airways CEO Bob Ayling changed the

London skyline during his four years with the organization. He championed the BA-sponsored London Eye Ferris wheel that towers over the Thames, commissioned British Airways' exotic new headquarters, and served as a chairman in the company that built and operated London's unprofitable Millennium Dome. Meanwhile BA slipped from being the world's most profitable airline to showing a loss of £200m.

Trivial pursuits: Managers obsessed with trivia put their companies in as much danger as managers obsessed with prestige. Shortly before Barclays Bank lost nearly everything in a failed overseas venture, two of the firm's grandees hit upon the key to trading success. They decreed: "Fish must be eaten with two forks, in the manner of the East Anglian Quakers." Such trivia often grows to squeeze out initiative.

Universities are classic examples of the law that the amount of trivia in an organization increases with its age. That is, the newer or more independent the school, the less trivia it has to weigh it down. Not surprisingly, in France the strong business schools are outside the university system; in Britain the leading business schools are independent or part of universities formed in the last 50 years. U.S. universities have not yet had time to accumulate the trivia and traditions that prevent their European predecessors from competing effectively.

Self-aggrandizement: *The Faber Book of Useful Verse* includes "The Advertising Agency Song": "When the client's hopping mad/Put his picture in the ad./If he should prove refractory/Add a picture of his factory."

Some CEOs have the same sense of ego, using their names and their images to communicate the firm's identity to stakeholders. Versace, Jack Welch, Body Shop's Anita Roddick, and Virgin's Richard Branson are all so strongly identified with their companies that their lifestyles and personalities reinforce the brand. Smart managers use the publicity they attract; others become seduced by their own myth.

The business press is partly to blame for this corporate vanity. Famous faces sell magazines, and business magazines are hungry for news of the superstars they helped create. However, publicity-hungry CEOs have to remember that only one thing sells magazines better than the face of a suc-



cessful personality: a celebrity scandal.

Egotistic CEOs, like despotic dictators, also look for chances to display their portraits everywhere. In the period before Barclays Bank fell from grace, its CEO took to traveling the world, visiting subsidiaries that the company should not have had anyhow. Then, to every overseas office he visited, he gave a very special gift—a portrait of himself.

Offshore adventures: Two recent banking fiascos resulted when companies tried to do overseas what they could not do at home.

Barings was the private bank of kings, a merchant bank that exuded respectability and was run by gentlemen. Nick Leeson, a plasterer's son working out of the bank's securities office in Singapore, bankrupted the company. Not only was Leeson offshore, but his office was ten floors below the people who were "managing" him. Most disastrous of all, Leeson ran the trading and the settlements office that acted as a check on the traders.

Barings had drifted into a business it did not understand. Lacking an appreciation of the finer points of the futures and options business, executives dreamed of a securities business with no risk attached. Therefore, they did not implement the usual risk management systems, according to Geoff Tibballs in *Business Blunders*.

Allied Irish Bank seemed set on repeating the Barings fiasco as it moved from being a very successful domestic retail bank in Ireland to losing control of a trading operation in the U.S. Both banks fell victim to the same double jeopardy: Having found out what they were good at, they tried something else in a new market. In grammar and multiplication, double negatives make a positive. In business, double negatives make a mess.

Other examples abound. Jean-Marie Messier transformed a utilities company into Vivendi Universal, a media giant big enough to challenge Rupert Murdoch. What are the transferable skills between a French water company and Hollywood's Universal Studios? According to *The Economist*, Vivendi Universal reported the largest annual deficit in French corporate history: a sum equivalent to

\$11.8 billion. He has since been forced to resign. Look out for any managers who think that running someone else's sexy business is easier than working at their own.

Miraculous rise: Barings managers let Nick Leeson ride because his cover-up made it look as though they had found the holy grail of moneymaking: getting something for nothing. During the dot-com boom, people bought shares in companies that promised quick riches even though they had no products to sell. Traditional business models were discarded; it was a time of mystery, excitement, and alchemy. Slogans replaced sound business thinking. For Vivendi, the slogan was "media integration." Companies like France Telecom and Deutsche Telekom discovered the "globalization of telecommunications." The dot-com mystery that made business logic unnecessary was the "leader's advantage."

Analysts now question the unremitting, market-beating rise of share price or profits. Shareholders love a company's profits and share price to grow steadily, in the way that GE's did between 1990 and 2000. Was it real or was it an accounting fix? During the 1990s, while the S&P index rose steadily, there were about 50 restatements a year for American corporations who adjusted their results after accounting errors. *The Economist* reported that the number of errors zoomed to 100 in 1998, and to 200 in 1999—just as the S&P's index approached its miraculous peak.

Beware of markets that, like hot air balloons, rise smoothly with no visible means of support. They are probably full of hot air.

Sycophantic syndrome: Groups of executives who have a great deal in common, who are insulated from outside influences, who are under stress, and who are dominated by a directive leader, are prone to "groupthink." They are not able to moderate the wilder schemes devised by chief executives and their vice presidents. Groupthink is often reinforced by the business culture and legislation. In Japan, a web of relationships across business, the civil service, and politics makes it difficult for people to make the tough decisions necessary to arrest the country's economic stagnation, according to *The*

Economist. France's business culture has a similarly cozy network where top managers sit on one another's boards. Enron was awash with such comfortable relationships.

Me too dumb: Groupthink can extend to entire industries, as businesses behave incompetently in unison. In the 1980s, U.S. housing trusts engaged in competitive overlending. More recently, banks in Hong Kong and Japan began overspeculating on property. Japanese steel companies have simultaneously diversified into microelectronics. Why have groups of managers converged to make the same bad decisions? Perhaps it's because they respond to the same media, are similarly trained, and influence each other's thinking at popular watering holes.

This pattern of thinking is reflected in much business practice. There is a myth that most new products fail. In fact, most of the products that fail are the droves of "me too" products that follow a smart idea. Similarly, most business strategies that masquerade as well-developed plans are simply following the currently popular panacea, be it conglomerate growth, vertical integration, or investing in the dot-com revolution.

Digging a hole: Politician Dennis Healey devised the law: When in a hole, stop digging. Business incompetence is littered with people who ignore the rule. In Singapore, Nick

Leeson gambled increasing amounts of money to hide earlier mistakes. Similarly, Enron devised ways of hiding its true debt. In Germany, Comroad's boss, Bodo Schnabel, took liberties with the company's accounts. Two-thirds of its 1998 revenue supposedly came from a Hong Kong account that did not exist. Having started digging the hole, Comroad kept digging. By 2000, the fictional account had grown to 97 percent of revenue. Imagine the hole in the accounts that this had left. Unfortunately, Comroad's auditors, KPMG, missed the problem.

Why do managers let their incompetence mount instead of facing reality? One reason is asymmetric consequences. If a manager owns up to an early mistake, a company might save money; however, the offending



Curing Incompetence

Can incompetence be cured? No, not while we are cultivating it so intensively. However, its impact *can* be reduced. Capitalism and democracy are systems that detect and punish incompetence, even though the systems don't function perfectly.

Failures like Enron occur because people behave illegally. Such behavior cannot be legislated against, although there would be fewer white-collar criminals if the crime and punishment were less asymmetric. The punishment is harsh for those who rob a bank, even though the cash stolen is an imperceptible fraction of the bank's worth. However, if, like Nick Leeson, you destroy a bank and write off billions of dollars of investors' wealth, you might get away with a short sentence and enough fame to create a best seller.

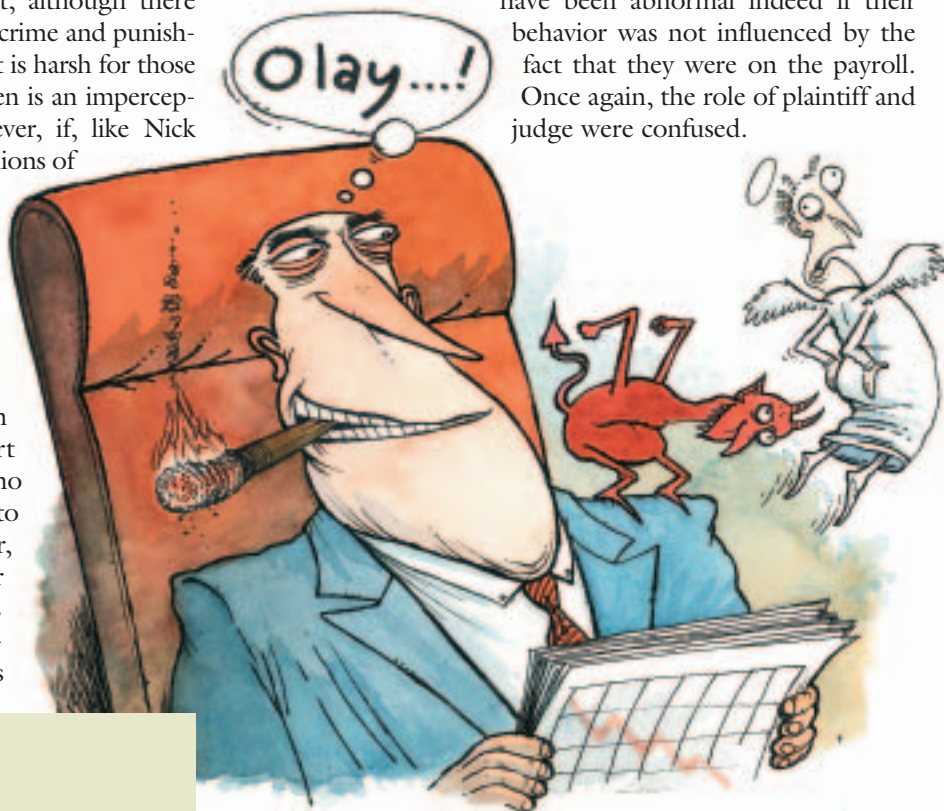
Governance and auditing should be checks on the most incompetent managers. The iron trinity of independent board chair, nonexecutive board members, and audit committee exists to keep a watch over shareholders' investments. A smart CEO would choose board members who question strategy and practices in order to keep top executives on their toes. However, in reality, the concentration of power among top corporations means that CEOs and board members swap positions regularly. They are less likely to be harsh judges

with business ethics and incorporates business logic. In the field of strategic management, students learn the importance of building strategies on relative advantage and differentiation rather than doing what everyone else is doing. This leads to lessons in entrepreneurship and innovation, where students learn the importance of good ideas. Decision making classes should stress the need for questioning strategies. Students also could use a rigorous understanding of the value of corporate governance.

Organizational behavior is the home for much of our understanding of business incompetence. MBAs must learn to identify the groups and structures that encourage incompetence, as well as the ways that people rise to incompetence. Then, perhaps, they will have the skills that will prevent them from making these same mistakes.

when at times they will be plaintiffs before the same people.

Even if a company's board is self-serving, an independent audit committee and auditors can act as checks. However, for an all-powerful chair/CEO, what is the incentive to create a troublesome audit committee? In the case of Enron, auditors were also acting as consultants to the company. They would have been abnormal indeed if their behavior was not influenced by the fact that they were on the payroll. Once again, the role of plaintiff and judge were confused.



Remember: Power corrupts, but absolute power is really nice. That is why so many people, from world leaders to top CEOs, behave badly. They are seduced by their own myths, their delusion of omnipotence, and the attitudes of paid sycophants.

Business incompetence will never be eradicated entirely. Smart stakeholders will look for the signs that a business environment and a business's relationships are shaped to suit managers, not shareholders—signs that relationships have become too cozy. Smart executives will look for signs that these same conditions exist in their own companies—and they will look for ways to eradicate them before the results of incompetence become catastrophic. **Z**

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