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Top 10 Bad Management Behaviors

Many companies' processes for planning, decision making, and performance management encourage undesirable behavior by managers.

Gregory V. Milano

Admittedly, when one reflects on the most significant bad management behavior, thoughts of Enron, WorldCom, and Tyco come to mind. And rightfully so: that list is full of criminal behavior that should absolutely be avoided. But there is another list of very undesirable managerial actions that don't attract news coverage. And those undesirable activities occur every day across corporate America.

Despite the best of intentions, many companies unwittingly foster a variety of planning, decision making, and performance management blunders. The collective result of these errors is a drag on corporate performance, shareholder returns, and, indeed, the overall economy.

For example, consider a general manager of a business unit that is rewarded based on improving return on invested capital (ROIC). At the end of the year, ROIC is calculated as the after-tax operating profit of the business divided by the invested capital (which includes working capital and net property, plant, and equipment). The ROIC measure is intended to indicate the efficiency with which a business uses its capital. Rewarding a manager for increasing the efficiency with which capital is deployed, measured, for example, by an increase in ROIC, would seem to be an honorable intention.

Let's examine the behavior this encourages. In 2015, the average ROIC of S&P 500 companies was 10.8%. For this illustration, consider a business earning a much higher ROIC, say 25%. This business would be in the top quartile among S&P 500 companies.

Any investment in this business that earns less than 25% will bring down the average return and reduce the bonus earned by the general manager. There may be investments that would earn, for example, 20%, and yet management would be discouraged from making the investment, since the ROIC would decline and the managers would earn a lower incentive bonus. Is this the right decision?

The core principle of modern corporate finance is that making investments that earn returns above the cost of capital creates value, and for most companies the cost of capital is around 10% or less. So this focus on improving ROIC inadvertently leads to underinvestment in high-return businesses, an approach that constrains growth and limits the potential for increasing the value of the business.

There are, of course, a myriad of these seemingly desirable management paradigms that encourage the wrong behavior. The following is a top ten list of bad management behaviors:

10. Mistaking Goals for Strategy. Some finance executives describe their strategy as being something like "doubling revenue, expanding margins, and growing earnings per share at double digit rates." Though these might be credible "goals," they are not "strategy." Strategy involves assessing the competition and environment, evaluating and enhancing competitive advantages, and choosing which markets to serve and which products or services to emphasize. Goals are generally meaningless without a strategy to get there.

9. Short-term Thinking and Asset Management. The increasing focus on quarterly earnings leads many operating managers to hang on to assets their companies don't really need. Selling or scrapping an asset for cash and tax benefits seldom comes at a convenient time from an EPS perspective. Tying up corporate capital in unneeded and underused assets is a drain on performance and an obstacle to success. That capital could otherwise be productively reinvested.

8. Living in the Past. In some cases, managers try to right the wrongs of the past by throwing good money after bad and considering sunk costs in decisions. In other cases they ignore evolving market conditions and manage as if the world stands still. And perhaps most importantly, managers are often obsessed with extrapolating the present into the future, all the while thinking good times or bad times will endure forever. This is particularly true in a cyclical industry. Executives in the oil industry will tell you all about it.

7. Micromanaging (especially capital). With processes that don't enforce accountability, many executives feel the urge to manage their subordinates very tightly. That discourages their initiative and weakens their feeling of ownership and accountability. This is particularly true with regard to capital expenditures. Because capital tends to be considered free after it is spent, executives feel it needs to be tightly controlled.

6. Over-investing in Poor Businesses. Managers in weak business units that are rewarded based on improving rates of return often over-invest. They do that because it is easy to find investments that will increase the average return when returns are very low to begin with. For example, if a company earns only a 3% ROIC, an investment that earns a 5% return will bring up the average ROIC and will increase the manager's bonus, even though this investment likely earns less than the cost of capital and destroys value. This behavior is reinforced in companies that use some measure of operating profit because earning any return on an investment increases both operating profit and the size of the incentive bonus.

5. Too Many (or Too Few) Acquisitions. Many managers pursue acquisitions "at any cost" to fuel revenue and operating profit growth. That helps them meet and exceed incentive bonus targets, which often are not adjusted for investments during the year. In other companies, an obsession with the myth that "acquisitions destroy value" keeps even good acquisitions from being considered properly. On top of these problems, many acquirers don't have clear, actionable plans on how they will integrate acquired businesses into their own to realize the benefits they project at the time they decide to invest.

4. Inflating Forecasts. The capital budget and the P&L budget are disconnected processes. The cash flows used to justify investments in capital approval requests rarely find their way into the P&L budget. That emboldens those who are requesting capital to provide inflated forecasts to justify investments. Thus, inflated forecasts render the approval process ineffective.

3. Pricing to Justify Costs. A focus on profit margin drives fully burdened, cost-plus pricing, which can exacerbate a slip in the win/loss ratio, especially, and/or an industry downturn. Losing business raises overhead burdens, which drives cost-plus pricing higher, reducing wins and further penalizing growth.

2. Underinvesting in Strong Businesses. As discussed above, managers in strong business units that are rewarded based on improving rates of return often underinvest. They underinvest because it is hard to find investments that will increase the average return when returns are already very high. This is made worse in companies that measure performance using free cash flow, which directly encourages milking a business as the full amount of an investment is subtracted dollar for dollar from the current year performance measure. This is ranked higher than over-investing in poor businesses because it is more common, more value limiting, and less recognized.

1. Sandbagging. Business units typically submit a three or five-year plan [every year] in which the first plan year is down but every year after that will be strongly up. The sandbagging provides an easy budget to beat in the annual incentive plan, and a strong outlook beyond that helps to get all their investments approved. This problem is potentially the largest under-appreciated problem in corporate America.

Why do companies establish policies that allow and even foster these bad behaviors? It comes down to managements having too much confidence and too little fact-based discipline. In the worst cases, fact-based approaches are shunned as “academic” or “theoretical.” Much like the baseball scouts in the book and movie “Money Ball,” many managers make too many important decisions based on “gut feel” and “experience” rather than a careful analysis of the facts.

The management processes in many companies simply don’t lead managers to gather enough information, including historical statistics on their own business. Even when they have the information, they often fail to properly use it in a rules-based manner to make objective, unemotional decisions.

Sound crazy? One company I worked with only filled in the cost, investment, price, and terms data in their pricing evaluation model after they had negotiated a deal with a customer – and this was on contracts worth hundreds of millions of dollars!

Undeniably, these management problems are not as sensational as the ones involved in the Enron, Worldcom, and Tyco scandals. But collectively, across thousands of companies, these common management pitfalls might well be costing society much more in terms of potential economic output, jobs, and wealth creation. Every company should take a careful look at each management process to ensure there are no adverse behaviors being encouraged.

Gregory V. Milano is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.