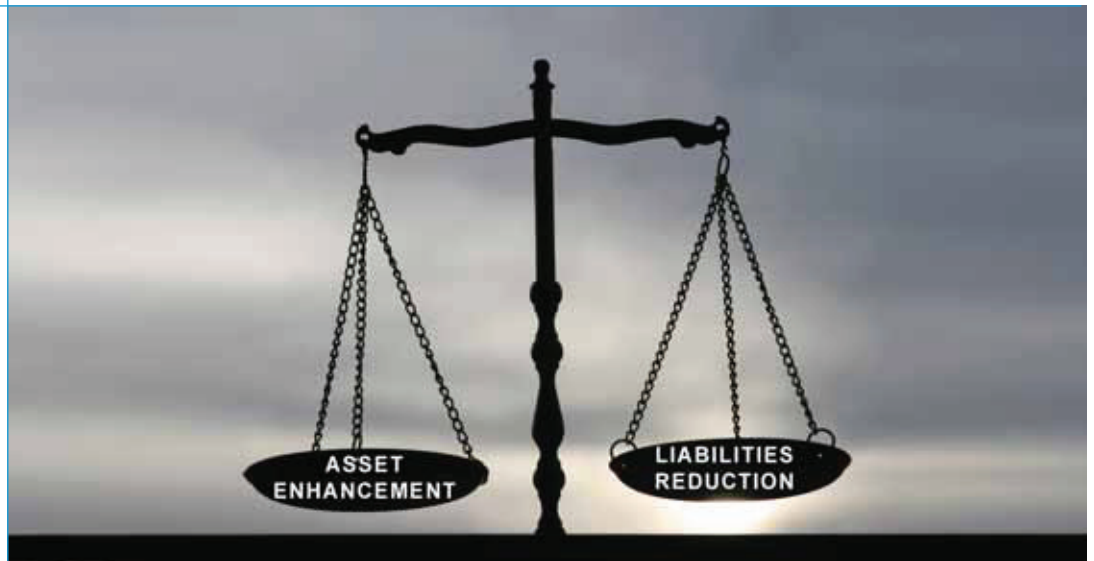




Leading Simply Without Being A Simpleton

Asset Enhancement versus Liabilities Reduction

Leaders manage complex work systems. Does it follow that leadership frameworks also need to be complex? Simple conceptual frameworks can sometimes inform important and complex systems. Think of Adam Smith's "invisible hand" or Benjamin Graham's concept of value as a guide for stock selection. Think of Maslow's Need Hierarchy. This article reviews the dynamic tension between two simple concepts – Asset Enhancement versus Liabilities Reduction.



In the early 1970's, Arthur F F Snyder, former Vice Chairman of Boston's US Trust, became a legend because he was willing to lend money to a new technology company called Prime Computer Company. Other bankers saw risk at Prime Computer, while Snyder saw an opportunity. When asked his philosophy behind the risky venture that scared other bankers away, Snyder took out a sheet of paper and wrote:

Assets and Liabilities
Snyder said these two words were more than the fundamental building blocks of the Basic Accounting Equation. It also was a statement about human nature. What he meant was that some people gravitate

towards asset enhancement as a way of providing value to organizations. Such people often see the world as one with full of opportunities. Their weakness is that they are prone to fall in love with their overly optimistic assessments. In terms of the Big Five Personality Dimensions, such people would be high on Openness and Extraversion.

But liabilities reduction is also a critical value. People who gravitate towards this side tend to see the world as full of threats. Their weakness is that they are tone deaf to value, lack vision, and place too much weight on threat. Using the Big Five, such people are low on Openness, high on





Stability, and low on Extraversion.

Snyder's philosophy about making credit decisions was to use the two concepts of Asset Enhancement and Liabilities Reduction as a framework to look at financial structure and power. At Prime Computer, he saw a strong CFO and a strong Chief Legal Counsel monitoring the liability side. He saw strong VPs of Sales and Marketing as champions of asset enhancement side. And he saw CEO Ken Fisher as structuring his role as being the final arbitrator between two powerful and conflicting forces. Snyder liked what he saw.

Simple And Precise

Perhaps leadership in a complex world ought to start from simple first principles. As a leadership principle, Asset Enhancement versus Liability Reduction is a principle that values the dynamic tension between these two competing values. It suggests staffing teams with strong advocates on BOTH sides. This formula sounds simple to the point of being simplistic. And yet, discussed below are four common fallacies that are linked to a lack of simplicity:

- ◆ The fallacy of alignment
- ◆ The fallacy of thinking like a business partner
- ◆ The fallacy of asking people to "think strategically", and
- ◆ The fallacy of skewing the CEO pay to align it with the needs of the stockholders.

We Are All Aligned

Our simple model of leadership says that conflict is natural. But the concept of managerial 'alignment' sees conflict as an aberration. 'Alignment' implies a common understanding of corporate strategy and linking/supporting everything down to individual job descriptions and compensation plans. Those who fight alignment must have a psychological

problem or they are so narrow minded they don't 'get it.'

Perhaps it is the very concept of alignment that needs to be changed.

Lehman Brothers was a classic alignment-driven company. The strategy was clear: increase assets and beat arch rival Goldman Sachs.

Richard Fuld did not view himself as the impartial arbitrator between two powerful forces. He was the Chief Asset Enhancement Officer aided by an aggressive sales/marketing function. Was the Liabilities Reduction Team given equal stature?

On May 16, 2008, SVP Matthew Lee wrote a letter to the CFO and the Chief Risk Officer complaining of "unlawful and unethical" conduct in violation of the Firm's Code of Ethics relative to its stated mandate of "full, fair, timely, accurate, and understandable" disclosure of financial information. This 14 year veteran of Lehman complained that "certain senior level internal audit personnel do not have the professional expertise to exercise the audit functions they are entrusted to manage." (*New York Times*, 2010).

A less dramatic but common example of the fallacy of alignment is when a family-dominated company staffs its Board of Directors or Board of Advisors with 'outsiders' consisting of college chums, friends from village, from the golf club, or the family corporate attorney. One can predict that the company's meetings will be harmonious and pleasant. Everyone will be aligned.

The price of 'We Are Aligned' is a reduction of the organization's ability to focus on the right problems that need to be defined.

Alignment can be a positive management concept in highly regulated industries where strategic flexibility is limited. Credit Unions, utilities, regulatory authorities, and insurance companies are examples.

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When a company strategy is flexible, the process of alignment can lead to dead ends like Lehman Brothers.

Your Line Manager is Your Customer and the Customer is Always Right

Human Resources is one of those functional areas that in theory contributes both to Asset Enhancement and Liabilities Reduction. Compensation, recruitment systems, and employee training touch all organizational boundaries. A common phrase within the United States HR business community is that HR professionals ought to think of their "line managers like clients."

It is a baby step from calling your customer a 'client' to 'the client is always

experience, most line managers want HR to focus on short term cost containment. They are not particularly interested in discussions about how talent management can improve customer attraction and customer retention. Should HR comply? Is the customer always right?

At Southwest Airlines, HR reports to the VP Sales/Marketing because Southwest sees HR as a tool for asset enhancement. At many American companies, however, many heads of HR find themselves functional peers of Controllers, both reporting to the Chief Financial Officer. Is it any wonder that they are professionally frustrated that the HR function is not treated with respect?

then I am told that I don't think strategically! I am doing what I am asked to do and now get penalized for it!"

A more precise way of getting at the same developmental issue is to tell executives that they have mastered being advocates for Asset Enhancement or Liabilities Reduction. Congratulations! If they aspire to higher positions, they must also demonstrate an ability to look at the same issue from the other perspective. If they aspire to be CEOs or heads of Strategic Business Units, the ability to take multiple perspectives on the same problem will be critical for their success.

Such a framework leads to concrete prescriptions such as "first define the problem from one side and then define

The price of 'We Are Aligned' is a reduction of the organization's ability to focus on the right problems that need to be defined

right' to measuring HR outcome as a function of 'client satisfaction surveys.' The concept of 'Your line manager is your client' places an implicit value on the primacy of harmony over conflict. Instead of being forceful advocates of a unique perspective that spans Assets Enhancement and Liabilities Reduction, viewing your line managers as clients may result in diminished effectiveness. In my

Think More Strategically

This developmental advice is sometimes given to high potential executives as a 'positive' suggestion for improvement. Telling an executive that he/she does not think 'strategically' can be perceived as being an insult. As one of our executive clients said, "I am paid to think tactically. I am rewarded for acting tactically. And

the same problem from the other side. If you can't easily define the problem from the side you normally favor, then say nothing and ask more questions. Perhaps you do not fully understand the issue."

For example, we are coaching an outstanding Internal Auditor who would like to be a Chief Financial Officer. But she acts like a policeman in a game of





Cops and Robbers. To move beyond “gotcha!” to serious contention for promotion requires an ability to articulate and appreciate Asset Enhancement even though her job today is biased towards Liabilities Reduction.

Skew CEO Pay to Meet the Needs of Shareholders

Boards have a fiduciary duty to represent the interests of ‘shareholders.’ Are shareholders a unified group? Institutional and individual traders are valid shareholders. Long-term investors are shareholders. In many companies, employees are shareholders.

Are the needs of these shareholders alike?

The reality in American business is that company Boards of Directors talk about skewing CEO pay to meet the needs of shareholders when they actually skew pay to meet the needs of institutional traders. These are people and organizations who plan to move in and out of their equity positions and seldom hold a stock for more than 18 months. The Lehman Brothers case would be a good example but there are many others.

The McDonald’s Board of Directors has been explicit about stating that its prime responsibility is to meet the needs of long-term investors – short term

traders be warned. This allows for a more precise calibration of CEO pay to achieve a balanced perspective from asset enhancement and liability reduction.

When Compensation Committees of Boards of Directors structure CEO compensation packages inline with low base pay and high year-over-year change in shareholder value, there is an explicit message to the CEO to favor short term asset enhancement over the interests of long-term investors. How can the CEO be an impartial arbitrator between the forces of Asset Enhancement versus Liabilities Reduction if the focus is on rewarding year-over-year appreciation in shareholder value?

When the Compensation Committee of the Board of Directors considers pay packages, does it review if the package is biasing the CEO away from being the final arbitrator or skewing the decision making? Does it bias the CEO towards Asset Enhancement or Liabilities Reduction?

If a Board is to ask the CEO to be the final arbitrator for Asset Enhancement versus Liability Reduction, then we would welcome some form of base salary and a three year average share price to be collected in three years each year. This is the program established at Goldman & Sachs and it is a great idea. We recommend that Boards be explicit

about what kinds of shareholders they are interested in focusing on and let other shareholders not complain that they were not warned.

One could argue that small cap companies cannot afford to take a three-year time horizon. Instead of focusing on the annual price of the stock, have the CEO focus on EBITDA over a two-year period. This is the purest form of ‘real’ net income devoid of tax avoidance engineering.

Summary

Leaders must lead in a world where complexity only moves in the direction of greater complexity. But leadership itself is built on simple principles. This article has articulated the simple tension between asset enhancement and liability reduction. We have seen examples where this tension is ignored rather than honored. But honoring the tension and staffing for tension may be a useful approach to leading in times of complexity.

To paraphrase a famous Beatles song, “Give Simplicity a Chance!”

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Reference # 03M-2010-10-08-01

