



Written by Amnon Danzig

Innovation from Within

For the past few years the “Innovation Phenomenon” has been the hottest topic around. Organizations and governments are striving to break the code: What is it? How to do it?

Consider the following:

- Worldwide, there is a consensus that innovation is the most powerful growth engine.
- Singapore government is devoting its 2010 budget to producing a dramatic improvement in productivity and innovation. They have declared it the mission of every citizen to contribute to this goal.
- Israel is one of the most innovative countries in the world. Every Israeli person dreams of creating a successful “start-up”.
- Many of today’s giant US companies were started in a garage by young people.
- Europe is lagging behind in innovation.

It is obvious that tiny firms and start-ups are very innovative: innovation is their bread and butter and the oxygen for their development. Wherever we go, people are talking and breathing innovation. But what happens when these small firms begin to grow? What happens within the more mature organization?

It’s a real challenge to preserve innovativeness as small companies are transformed into larger organizations. Why do these larger organizations tend to suffer from a severe lack of innovative spirit? The following article will explore this question and present a number of recommendations, which theme is *Innovation from Within*. We might also call it “*Managing from Within*”, because with correct management from within, in our view, innovation will follow. Let’s take a deeper look.



Our first task is to understand the basic dilemmas involved in managing an organization. This in itself is already a complex matter, but when we add the innovation dimension--we're in a whole new ball game. We shall attempt to illuminate some aspects of innovation in the management arena.

What is the essence of management?

The management of an organization is analogous to a person who has to work with both hands simultaneously: the right hand manages the *current organization*; the left hand manages the *future of the organization*.

➤ Managing the current organization

Here, the managers should focus on utilizing the company's resources and capabilities to exploit opportunities in the most economic manner possible. They must monetize the organization's most valuable assets: the sum of the internal and external relationships the organization has built in the past.

➤ Managing the future of the organization

Here, the management team must be able to see beyond the current "fog" and anticipate how the future is going to look. Needless to say, reading the future is not a linear task. Opportunities must be sought, and a road map created to prepare future capabilities that will allow those opportunities to be harvested.

This, then, is the mission faced by every organization: the development of *both* capabilities: managing the "current" organization, and preparing the organization for the future.

Let's elaborate the two time horizons in greater depth.

Managing the "current" organization

In the last century, two rival economic systems led the world: **capitalism** and **communism**. Two polar opposites. The former is all about "the invisible hand": if the citizens are allowed to act according their own interests (within moral and legal constraints), both individuals and the



society as whole will prosper. In the long run, the resources of the society will be exploited in the most efficient way. The latter is all about central governance: economic planning and execution are in the hands of officials.

Capitalism nurtures the innovative spirit. It encourages people to invent, to explore and to develop entrepreneurship. Why? Because there is no “big brother” dictating to you what can and cannot do. You have to find your own way, developing your skills to seek and ensure a better life for you and your family.

Communism does just the opposite. The powerful few “know what is best” for all, and they have the authority and responsibility to dictate the lives of the many. It’s hardly surprising that in this kind of environment, the innovative spirit cannot flourish.

If you agree with the above, I would like to ask you a pointed question: in your organization, does the governance culture tend toward **capitalism**, or toward **communism**?

Say what? Really...Well, if you can’t say, let me put the question differently: is your system centralized, or open like “the invisible hand”?

Consider this: the five year plan is like strategic planning. The budget is a perfect example of the command and control environment.

Are we agreed, then, that in your specific company (just like in any other organization) the culture is more like **communism** than **capitalism**?

To take the analogy one step further: you say you want innovation, but how on earth can it exist in a communist environment?



The obvious solution would be to make processes more flexible, moving much closer to the freedom you hope to enjoy in the country where you live. But here we face a major dilemma: how can the CEO and his team trust the organization to steer itself in the right direction? How can the management team be sure that the resources of the firm will be allocated in the most effective and efficient way?

The answer is to create a *sense of ownership* within the organization. In order to develop the ownership phenomenon, we first measure the economic outcome of the current activity. We then pay our employees according to the economic results. If we do this successfully, the management team can rest assured that each and every employee will feel ownership of their operation, and will act accordingly. When this happens, the management team can begin to migrate from the “**communism pole**” to the “**capitalism pole**”, paving the way for the rise of that entrepreneurship we all seek.

Our recommendation:

Put in place a sophisticated measurement system that is robust, transparent and reflects the economics of the firm. Make sure this system is capable of measuring the different dimensions of the organization: operation, BUs, product lines and services, operations on the shop floor, R&D, sales, marketing and support activities. The economics of these entities must be accurately measured. All planning and screening processes should be aligned with the new system.

Next, construct a remuneration system based on the new measurement system--the measurement system accurately reflects the economics of the company as a whole and is capable of drilling it through to the various dimensions and levels of the company. Aligning the measurement system and the remuneration system will create the “multiplier effect”: through correct measurement and proper compensation, your employees will become your partners. Not only will they develop a sense of ownership, they will also seek innovation. Why? Because they will behave like owners, striving to maximize outcomes while utilizing resources wisely.



This is the concept of *Innovation from Within*. It is the real innovation part of the management processes.

Managing the “future” of the organization

As we have said, the management team must be able to see past the “fog” of the present and anticipate how the future is going to look. Planning for the future is not a linear task. Numerous possibilities must be considered, opportunities sought, and a road map created to develop the capabilities that will allow those opportunities to be exploited.

It is a common assumption that the CEO and management staff have the heroic ability to see through the fog and accurately chart the future of the organization. We disagree. Reading the future is huge task. It involves many dimensions: geography, demography, macroeconomic factors, technology, and client preferences--industry-specific and other. Sorry, but this is beyond even the abilities of “heroes”.

We strongly believe that in any healthy organization, there are many people who have developed certain capabilities we call “strategic”. The question is, how can they be brought together as a single unit, sharing common vision and goals? Again, *Innovation from Within* might serve us well here.

Most organizations leave matters of strategy to the most senior staff, claiming that by virtue of better education and experience gained from their service in other industries, they are best equipped to see ahead. Agree. But suppose we dedicate an effort to educating mid-management to think “strategy”. By equipping them with the relevant knowledge, we will gain two merits: (1) current activities will have more of a mid- and long-range perspective; (2) the strategic process will be fed by a wider and deeper knowledge about the industry itself. Those CEOs who understand their role as “leaders of the revolution” from within, will gain huge support. Planning will be based on more in-depth knowledge, and the execution will be met



with much less resistance. Mid-management will feel ownership for the next phases.

Here we face another obstacle: when mid-management begins to be involved in matters of strategy, many ideas will be brought to the table. The CEO may claim that when too many people are dealing with the future of the company, nobody will be in charge of how to manage the profit and loss statement. Spending money today to gain latter prospects will hurt the current profitability of the organization. Why should senior managers agree to it?

The answer is a robust and transparent measurement system that knows how to deal with future expectation on the one hand, and how to reflect it in the same currency as an “actual” on the other. Allow me to explain: future expectations are usually measured by FCF (Free Cash Flow). This is translated to the present time by discounting it with the factor that represents the risk of the future activity. When the organization faces the expectation (“becomes actual”), it is measured by profit and loss methodology, not cash flow. This is the drawback of the FCF (Free Cash Flow) methodology.

We must find a different methodology, one that will align future expectations with the current measurement system. The EVA Concept is well-equipped to deal with this problematic situation. This situation can be bridged by the present value of EVA, which is identical to the present value of the FCF.

In the case of initiatives that are not entirely new projects, we can deal with these using the framework Stern Stewart calls “strategic investment”. It can be applied to restructuring of the business in all its aspects: organization, marketing methods, R&D practices and the like. These are some of the adjustments Stern Stewart suggests in order to migrate from the accounting framework to the economic framework.

The idea is to flex the constrained thinking that arises from the desire of senior managers to “manage profit and loss”, creating a much more proactive attitude. Again, the right



measurement system must be in place to reflect the economic reality of the organization. This is not the place to discuss how the measurement system should be built; we will merely note that the EVA Framework, when constructed properly, provides full support for the issues raised in this article.

Let us sum up:

Innovation is the most powerful engine for growth. Small organizations and start-ups enjoy the spirit of entrepreneurship, which is the bedrock and the soil for innovation. The main problem we face in larger and more mature organizations is how to establish and develop the desired entrepreneurial spirit.

This article claims that the solution lies in fostering a *sense of ownership*. This is *our* operation. *We are the owners* of the end results. What's more, we're going to gain from it, as well. How many times have we heard the claim that "our employees are our most important assets"? Sorry, but this is pure BS. For a simple litmus test, ask yourself the following questions:

- Do we treat our employees as business partners?
- How much freedom do we give our work force?
- How do we characterize our culture: "command and control" or "freedom to think and act"?
- How do we measure results?
- How do we compensate our work force?

Understandably, the culture in most organizations tends to be more "**communist**" than "**capitalist**". Senior managers believe that if they relinquish central control, resources will not be exploited in the most efficient and effective manner.

The solution is to develop a *culture of trust and respect*. Granted, this won't be easy. The first step is to develop two components that will work holistically:



- A measurement system that reflects the economics of the organization--past, current and future--and has the capability to drill it down to the shop floor and the various dimensions of the organization: BUs, operation, sales, marketing, R&D, product lines, and support activities.
- A remuneration system that will allow the work force to share the economic outcome of their efforts.

This will enable senior managers to flex managerial processes: much less planning “from above”, many fewer approval processes.

Now that the company has begun moving from the “**communist**” pole toward the “**capitalist**” pole, we make a major innovation in management methodology. This, in turn, will boost the creativity of the entire workforce. Call it *Managing from Within* or *Innovation from Within*--now you know they are one and the same.

The good news: an entrepreneurial culture can now develop, and when it does, it will dramatically boost the spirit of innovation in your organization.

Good luck.

Amnon Danzig

Singapore, July 2010