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WHY COMPANIES FAIL? THE BOILING FROG SYNDROME

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ABSTRACT

Why do nations fail? An answer is given by Acemoglu and Robinson (2012) by pointing out the importance of institutions for an economy that leads to innovations for economic growth. Christensen (2012) asks a similar question for a firm and diagnoses why companies fail. This study relates Acemoglu and Robinson (2012) with Christensen (2012) in order to better understand how to make companies more prosperous, powerful, healthier, and live longer via innovations. In order not to cause a company to fail, instead of traditional financial ratios, in addition to understanding types of innovations, right metrics and incentives have to be employed in order to foster the innovative environment in a company. Only then companies are able to avoid slow, persistent deterioration that will result in fatalities, the boiling frog syndrome.

KEYWORDS: Why Companies Fail, Innovation, Company Performance, Performance Measurement & Right Metrics

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INTRODUCTION

Even the once considered great companies fall and disappear after a while. An immediate question follows: what makes a company more prosperous, powerful, and healthy? Is it the resources they have or is it the way the resources are used? An analogous question –why nations fail- is answered by Acemoglu and Robinson (2012) titled "Why Nations Fail: The Origins of Power, Prosperity and Poverty."

According to Acemoglu and Robinson (2012), institutions are the key to explain economic development differences between nations rather than geographic reasons, i.e. resources. One nation might have abundant resources, but this doesn't necessarily mean that the nation would be prosperous and away from poverty. Whether the nation has a good set of institutions decides the prosperity level. They give anecdotal evidence from old times to the modern world. (Of course, one may claim that without abundant resources, a nation cannot achieve full economic development; the role of geography is much more important. Please note that the controversy over the roles of geography and institutions in economic development is a long debated topic that is beyond the scope of this article.)

The striking example they give is the city of Nogales right at the border between Mexico and the US that is divided by fences into two parts; the US part –the north Nogales, and the Mexican part –the south Nogales. There are big differences between the north and the south Nogales not only in income levels but also in schooling, infant mortality, life expectancy and so on. However, there is not much difference between the people in terms of their culture, origin or so, if there is any at all. In addition, one side of the fences does not get more rain or natural resources than the other side. Hence, these cannot be the source of differences between the north and the south of Nogales. Rather it is the institutions they have at each side that create the differences according to Acemoglu and Robinson (2012).

Why are institutions so important and make an incredible difference at the end of the day? It allows a running government, a just judicial system, well-operating markets under the protection and regulations of the government and its laws, protection of intellectual products, and most of all, for the purposes of this article, creating a friendlier environment for innovation in all areas including production of goods, services, and processes.

Innovation is the key. It greases the wheels of the economy so that they run smoothly and faster without groaning and wearing out much. If innovations are not there, the wheels will lose their grease, hence speed and pace. At some point, the system will fall apart.

FROM NATIONAL LEVEL TO FIRM LEVEL: ASKING THE RIGHT QUESTION

We can think of companies as the wheels of an economy. If anyone wants to have a well-running economy, greasing it is the solution. But that means greasing companies in that economy. In a more formal language, leading companies to innovate is the key in running an economy well.

At this point, the question turns into what kind of grease should be used? That is, innovations are of the essence but are all innovations the same? If not, then what kinds of innovations are beneficial? What kinds of innovations make companies more prosperous, powerful, healthier, and live longer?

These questions are rephrased in a condensed way and are answered by Christensen (2012) - A Capitalist's Dilemma, Whoever Wins on Tuesday." He named the problem as "a capitalist's dilemma." In addition, Christensen and Bever (2014) revisit the problem in detail.

Recall that in modern teachings of an economics course, the basic problem is the maximization of profit with respect to scarce resources: land, labor, and capital. If a resource is abundant, it does not restrict the problem, hence can be disregarded or that source can be wasted should there be a need for. Recall the Quantitative Easing One (QE1) that the Federal Reserve (FED) carried out, and then QE2 and then QE3, and then searching of exit strategies by the FED in recent years together with European Central Bank's (ECB) actions making capital almost free, drawing down the interest rates close to zero. Under such abundant capital, the assumption of -capital is scarce- is not valid anymore. Rather than being scarce, capital is abundant. So, does it make any difference? If so, how? What would be the effect on the maximization problem results?

Christensen (2012) draws peoples' attention to the abundant capital, hence, to the changing conditions at the basic maximization problem of a modern firm. In other words, maximizing profit with respect to the scarce resources, land, and capital, is not the correct problem to solve if capital is not scarce.

ABUNDANT CAPITAL, TYPES OF INNOVATIONS AND RIGHT METRICS

Indeed, capital is at everywhere but nobody wants to invest in innovations that grease the wheels of the economy that will lead growth. Before going forward, Christensen (2012) defines types of innovations. According to his classification, there are three types of innovations: empowering, sustaining, efficiency innovations.

Empowering innovations "transform complicated and costly products available to a few into simpler, cheaper products available to the many… Empowering innovations create jobs because they require more and more people who can build, distribute, sell and service these products. Empowering investments also use capital - to expand capacity and to

finance receivables and inventory."[2] One may think of the development of computers from big and heavy devices to today's tablet computers and smartphones as empowering innovations.

Sustaining innovations "replace old products with new models… They replace yesterday's products with today's products and create few jobs. They keep our economy vibrant — and, in dollars, they account for the most innovation. But they have a neutral effect on economic activity and on capital."[3] Automatic cars provide more convenience but every time a person buys a car he/she has to make a choice between an automatic car and a stick shift.

Innovations on existing products and services that reduce the cost of making and distributing them are called efficiency innovations. These have two crucial functions: the first improves productivity, and the second is freeing up capital for more productive uses. Although the first is essential to be successful in competition, it may cause an undesired byproduct, eliminating jobs due to automation.[4]Walmart's business model is an example of efficiency innovation.

Empowering innovations create jobs and increase consumption by its very definition. Efficiency innovations destruct jobs but free up capital. If the freed-up capital is invested in empowering innovations and if resulting job creation is higher than efficiency innovations' destruction, then such an economy grows.

Christensen and Bever (2012) rename sustaining and empowered innovations in more market-friendly names as performance-improving and market-creating innovations respectively.

Christensen (2012) and Christensen and Bever (2012) propose a prescription for companies to grow, and hence for economies. However, if it is so easy, why do we still see failures then? The answer in economics is the incentive set used; it is metrics, key performance indicators used in management science. If they are not aligned right with goals and not calibrated well, the results will divert from growth to either slowed growth or even worse no growth at all.

In the discussion, one needs to keep the basic problem of the modern firm in mind: maximization of profit subject to the scarce resources like capital. However, that produces metrics like Return On Net Assets (RONA), Return On Capital Employed (ROCE), or Internal Rate of Return (I.R.R.). These are ratios. "Building long-term value for a company is far more complex than achieving near-term financial results."[5]

Innovations can be done to get better ratios, and those would not be empowering innovations, rather, they are sustaining and efficiency innovations that do not create growth. "Continuing to measure the efficiency of capital prevents investment in empowering innovations that would create the new growth we need because it would drive down their RONA, ROCE, and I.R.R."[6] That leads to focusing on only short-term priorities. Margolis (2008) draws attention to the importance of employee motivation and commitment in order to achieve a business environment fostering innovation, which is the source of healthy long-lasting growth. Margolis (2008) also points out that companies focus on past data. i.e. short-term profits. According to Berman (2007), "[a] company really runs from the top down. Employees do what management expects of them…" If the management of a company focuses on RONA, ROCE, I.R.R. or similar ratios, the whole company will adjust its focus accordingly, which will lead to failures in the long-run. In addition, these are the ratios, which focus on only a company's own figures. However, every company is in a competitive environment; either

[2]Christensen (2012).
[3]Christensen (2012).
[4] For more on this topic, see, Ozcan (2017a) and Ozcan (2017b).
[5]Margolis (2008).
[6]Christensen (2013).

having direct competitors or potential competitors awaiting on the sidelines. Likierman (2009) also points that focusing only return on investment, a similar metric like the ones mentioned before, will cause making fatal mistakes in managing a company.

CONCLUSION: BOILING FROG SYNDROME

Given an incentive scheme, decision makers make their decisions accordingly. That is to say, an executive does what is right from his/her perspective under the assumption that the capital is scarce. However, in an environment that capital is not scarce the whole question and its solution change. Hence, there is the dilemma, as named by Christensen (2012) as the capitalist's dilemma; doing the right things in the wrong scenarios. According to Christensen and Bever (2012) "[doing the right thing for long-term prosperity is the wrong thing for most investors, according to the tools used to guide investments. In our attempts to maximize returns to capital, we reduce returns to capital."[7]

The question is what to choose; empowering innovations or sustaining and efficiency innovations. Positive effects of the first would take some year to be seen on the current measures; hence, compared to the second choice the ratios would be worse. By choosing to sustain and efficiency innovations would result in freeing up some capital now, which will make ratios better in the short-term; however, due to empowering innovations the company would suffer in the long-term. I call this the boiling frog syndrome; it seems okay or nice in the short-term, but in the long term it slowly boils up causing fatalities.

Hence, understanding the types of innovations, application of the boiling frog syndrome to the subject and existence and meaning of the capitalist's dilemma are the initial crucial steps in preventing companies from failure.

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[7]Christensen and Bever (2014).