Growing Up

transitioning from founder-driven start-up to well-managed organization without losing the entrepreneurial spirit

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As companies grow, they inevitably must transition from founder-driven start-ups to well-managed organizations.

At this transition point, a firm has sorted out its mission, vision, and strategies; and it has viable products. Its next hurdle is building a strong, empowered leadership team and mature organizational processes that can drive the next stage of growth.

There's more to this challenge than just installing a seasoned CEO or CFO. This white paper explores the processes needed to make a growing organization work.

The Problem: Bottleneck at the Top

The transition challenge occurs when complexity has grown to the point where one individual (such as a founding entrepreneur) can no longer personally manage everything.

This critical juncture typically occurs somewhere between US$50 and $250 million in revenues, or as staffing grows beyond 50 people. The greater the complexity – diversity of functions, disciplines, channels, and geographic dispersion – the sooner transition challenges arise.

At this transition point, the founding CEO risks becoming a bottleneck.

Worse, he/she may be involved in decisions that subordinates are better equipped to make. As a result of micro-management, mistakes are made and strong leaders may be driven away.

Meanwhile, a CEO immersed in operational management doesn't have enough time to focus on the strategic decisions and external relationships where he/she is most needed.

When this occurs, the founder who created the company ironically becomes the constraint to its continued success.

In some cases, the need for change is recognized by an insightful founder. In others, it's demanded by members of the Board, bankers, or involved investors. If the founder is replaced, navigating the transition is central to the new CEO's mandate.

In all cases, the way this transition is handled determines whether or not the company will continue to grow while preserving the entrepreneurial character and values that made it successful in the first place.

The Solution: Three Legs of the Stool

To eliminate the bottleneck at the top and refocus the CEO on strategic issues, management authority must be shared with a coordinated team of leaders.

To make this possible, like three legs of a stool, three things are needed:

Leg 1: The founding CEO must learn to manage through others and to focus his/her personal attention on strategic challenges (or step aside).

Leg 2: Senior leaders at the next level must evolve from functional experts to business leaders.

Leg 3: Senior leaders must be empowered to run their respective organizations, necessitating organizational processes to coordinate and control independent groups within the organization.

Leg 1 is well understood. Some founders are able to grow into the role of organizational executive. For those who do not, it's not uncommon for a Board to replace (or complement) the founder with a "professional manager."

Leg 2 is also well understood. Board members and investors offer mentoring and coach executives on strategic decisions. Some firms take advantage of leadership development programs such as Executive MBAs. And in some cases, seasoned executives are hired into senior leadership positions.

Leg 3 is the challenge explored in this white paper.

Leg 3: Discipline Without Bureaucracy

To tap all the talent that's already in the organization, the next tier of leaders must be empowered to manage their respective parts of the organization, exercise their creativity, and work directly with one another without the need for day-to-day involvement of the CEO.

"Don't tell people how to do things;
tell them what to do and let them surprise you with their results."

George S. Patton

However, empowerment cannot mean chaos. Everyone must be aligned with strategies; resources must be controlled; and activities must be coordinated – functions formerly done by the CEO.

Disciplined business processes must take the place of an individual at the top personally governing resources and coordinating everybody's activities.

Key to a successful transition is installing business discipline without destroying the entrepreneurial culture on which the company was built. If processes are badly designed, firms become bureacratic and ineffective.

The answer to this connundrum – discipline plus entrepreneurship – can be found all around us: Manage every department, or group within a department, as a business within a business, producing products and services for customers both within the company and externally. *[1]*

As in any market economy, there's an internal supply chain for each of a company's external products and services. A product manager is held accountable for the profitability of a product line. As the "prime contractor," he/she "buys" services from peers throughout the company.

> For example, a product manager may buy market research from Marketing to hone the concept of a new product. Then he/she may buy designs from Engineering, and help with business planning from Finance.
>
> Once the product is ready to go, a product manager buys production from Manufacturing, which in turn may buy modifications to plant infrastructure from Engineering and help with sourcing from Procurement.
>
> With inventory in hand, the product manager may buy warehousing and distribution from Logistics, promotions from Marketing, and selling from the sales force.
>
> In parallel, he/she buys support services from IT, HR, Finance, Legal, Facilities, etc.

Note: The word "buy" is used here to emphasize the concept of market economics applied within organizations, *whether or not money changes hands.* Transfer prices and accounting chargebacks are not needed to make this concept work.

All that's required is clear agreements among peers about what each will provide to one another.

Employing the business-within-a-business paradigm, managers throughout an organization can be empowered to run their departments as they see fit without any loss of coordination or control. The CEO and the Board have the information they need to align resources with strategies, and to manage the next tier of executives based on results. Thus, they can move into the role of coaches rather than micro-managing leaders who control all key decisions at the top.

Financial Governance

There's no need to worry about a loss of control with this kind of empowerment. With internal entrepreneurship, financial controls are comprehensive. Executive control is exercised by deciding what deliverables to fund, not by controlling what managers spend.

With internal "revenues" constrained, spending is controlled because every group must break even.

> Keep the lights on services: Funding for operational (production) processes come from internal customers.
>
> Strategic initiatives: When executives approve new initiatives, they supply funding sufficient to cover all the needed elements of the internal supply chain.

Since managers must not spend more than their internal revenues permit, anything that's not funded doesn't happen.

The only exceptions to the break-even requirement are product managers who sell the company's products and services to external customers. They are managed to traditional targets like profits, margins, market share, and customer loyalty.

Thus, the CEO has the same tight control over resources as he/she would have by personally making every spending decision.

Tight cost controls need not stifle innovation. Metrics focus on results (rather than how people deliver those results), giving managers room to experiment, to evaluate what worked and what didn't, and to invest in innovation within the context of clear objectives.

"Innovation is the spark that makes good companies great.
It's not just invention, but a style of corporate behavior
comfortable with new ideas and risk."

Peter Drucker

In addition to strategic initiatives funded by executives, innovation occurs because internal entrepreneurs include in their pricing the necessary sustenance activities such as professional development, process improvement, and technology innovation. With these indirect costs varying in proportion to sales, the level of innovation and support remains in proportion to the business.

In an entrepreneurial organization, metrics can go beyond just the numbers. All managers can be evaluated on customer satisfaction because they have clearly defined internal customers. Evaluations can also include entrepreneurial metrics like cost control (using external benchmarks such as outsourcing), and economic value *[2]* including the many types of innovation that keep each business-within-a-business viable in the future.

Benefits

In this kind of organization, managers become entrepreneurs who strive to earn their internal customers' business by offering the right products and services, excellent value, and a customer-focused culture. To do so, they manage their costs, deliver on promises, innovate, and team with peers and vendors to optimize their value propositions.

Cost savings occur naturally at two levels:

* Managers eliminate indirect costs that aren't essential to the delivery of their groups' products and services because they must offer their internal customers competitive value.

* Internal customers eliminate low-value support services which they don't need (even if they are a good deal).

  For example, it may be the job of the IT department to deliver great technologies; but that doesn't mean it should be funded to do so. Not every application enhancement is worthwhile, and not every service needs to be delivered at the highest level of availability. If other departments choose not to buy some IT projects and services because they deem them not worthwhile, then IT internal revenues (and hence spending) are reduced without material loss of productivity in the business.

Individual performance improves when managers focus on results, not tasks.

Company performance improves when all departments are aligned with key strategies. Teamwork and alignment occur naturally because each manager buys (internally) whatever is needed to deliver the products and service he/she has agreed to sell.

Thus, teams form laterally, without the need for the top executive to plan everything. And all activities are focused on key results.

"Market economics is the most powerful mechanism of social coordination known to mankind."

Dr. Charles "Ed" Lindblom
professor emeritus of political science and economics
Yale University

Shareholder value is further enhanced through better resource-allocation decisions, since all funding is linked to deliverables.

* For existing product lines, executives have the information they need to judge product-line profitability and the availability of funds for growth initiatives such as new marketing programs, product-line innovation, and internal process improvements.

* For new enterprise strategies, executives have a realistic view of the total cost of proposed strategies – not just the obvious direct costs, but their impacts enterprisewide.

Furthermore, investor confidence is built through financial transparency before the fact, not just after results are reported.

To directly address the transition challenge, empowerment of the leadership team eliminates bottlenecks at the top and gives the company a broader leadership team with unlimited growth capacity.

The resulting entrepreneurial culture taps everyone's creativity.

Meanwhile, learning to manage their internal entrepreneurships develops the business acumen of members of the founding team (who have great industry and product experience). Those who embrace the method and learn to run a business become the next generation of leaders. This may avoid the need for some of the familiar turnover – a waste of the talent and knowledge that's critical to the company's continued success.

In the "real world," market economics inspires entrepreneurship while optimally allocating scarce resources and coordinating unthinkably complex supply chains. It can do the same within organizations.

Practicality: Business and Financial Planning

The business-within-a-business paradigm can be used to guide the design of the many business processes needed to mature a founder-led start-up into a well-managed organization. The question is where to start.

Typically, the best place to begin is an annual business and financial planning process which engages leaders in establishing their individual objectives, empowers them with budgets, and coordinates their independent operational and strategic initiatives. *[3]*

In the business-within-a-business paradigm, annual business plans take on a unique form, quite different from bureaucratic budgets which encourage managers to spend all they've been given (perhaps wastefully). Entrepreneurial budgets are linked to a business plan and describe what each group will *sell* (deliverables), not just what it will spend.

This induces a dialog with internal customers about their needs, and aligns the many internal supply chains.

Then, funding is awarded based on what the company chooses to buy from each group – termed "Investment-based Budgeting." *[4]* The executive team makes budget decisions based on the costs and value of the products each department proposes to sell – the investment opportunities at hand – not arbitrary benchmarks like last year's spending or current staffing.

Investment-based Budgeting is a very practical first step in bringing discipline to transitioning companies. The Appendix explains how it works, step by step.

Building on the Planning Process

Of course, once the business plan and budgets are established, things change. Shifts in economic conditions, world events, the competitive landscape, and new opportunities all conspire to demand continual adjustment of the plan.

Here too, the business-within-a-business paradigm provides guidance. As things change, managers may choose to buy a different mix of products and services from their internal suppliers. As a result, internal supply chains adjust and priorities remain synchonized enterprisewide.

With each manager adjusting to changing requirements as needed – without having to wait for a decision from the top executive or another time consuming written plan – companies become more flexible and agile and yet still well controlled as top executives manage the what, not the how.

Conclusion

When a growing company faces the inevitable transition from founder-led start-up to a well-managed organization, it takes more than the right talent, whether that's developed internally or brought in from outside.

It takes more than mentoring, whether provided by the Board or a professional coach.

Growing organizations need to install the right organizational processes to structure the knowledge and insights of the leadership team, develop information for effective decision making, and offer investors financial transparency.

With the right processes, there's no need to fear unproductive bureaucracy or loss of creativity. Investment-based Budgeting encourages customer focus, entrepreneurship, individual accountability, teamwork, and innovation at every level of management.

A disciplined, entrepreneurial approach to business and financial planning improves the effectiveness of every aspect of a complex, growing company. It will support a growing company indefinitely – an investment that pays off for years to come.

Investment-based Budgeting is a practical, straightforward, and effective way to evolve a founder-led firm into a team-based organization with unlimited growth potential.

Appendix: How Investment-based Budgeting Works

Investment-based Budgeting is a business and financial planning process that has four basic steps:

1. Product/service catalogs

First, every manager defines or revises his/her group's catalog of products and services – specific deliverables provided to customers inside and outside the company.

This step requires managers to translate "what they do" into "what they sell" – understanding their work through the eyes of their internal customers. Doing so brings about a focus on results, a definition of each group's accountabilities, and an understanding of its competition (other sources of its products and services).

***"My job is to get budget at the beginning of the year,
and make sure it's used up by year end."***

anonymous manager in the US Department of Defense
illustrating the opposite of internal entrepreneurship

2. Business forecasts

Next, managers forecast which products and services their groups will sell to each of their internal and external customers. Of course, at this step, the forecast is just a proposal; sales are subject to customers' agreements. This step brings about internal customer focus.

In addition to sales to internal and external customers, entrepreneurs may propose to sell "corporate-good" services to the Board – for example, policy planning and community-action projects. Keeping these enterprise initiatives separate from sales to specific internal customers ensures that product and service costs are comparable to external benchmarks like outsourcing.

Entrepreneurs may also propose "venture" projects, requesting funding for research and development, or to improve their capabilities such as capital for infrastructure or investments in internal process improvements. These investments may later be depreciated, with the depreciation expense imbedded in the cost of customer products and services.

3. Fulfillment plans

Resource requirements reflected in a budget are, of course, driven by the deliverables proposed in the business forecasts. (As logical as this may be, many bureaucratic organizations develop budgets without any definition of what is expected of them in the coming year!)

First, managers develop staffing strategies that describe the people they'll need (both employees and contractors) to fulfill the plan.

Then, they forecast other costs – both direct and indirect, and both capital and expenses – which they'll incur in the course of producing planned deliverables and running their groups in a sustainable manner. Indirect costs include sustenance activities like training, product innovation, process improvements, and relationship building.

All costs in managers' plans are subjected to scrutiny by executives (or even the Board) to ensure frugality. Financial transparency provides a factual basis for healthy dialog.

All costs are then attached to the proposed products and services. Indirect costs are amortized such that the cost of each product and services represents the true, full cost *[5]* to shareholders of each internal purchase decision.

4. Budget decision making

The budget decision-making process then becomes a matter of deciding what to "buy" from each internal entrepreneur. This induces dialogs between departments about what each will need from one another, leading to the alignment of internal supply chains.

Executives then allocate funding to each department based on the value and the full cost of approved deliverables. *[6]*

If downsizing is necessary, the same thought process works so much better than traditional hiring freezes and across-the-board cuts which cause things to fail randomly and cripple the company's ability to do anything well. Using Investment-based Budgeting, executives can surgically cut lower-payoff deliverables while maintaining all the funding needed to succeed at strategic deliverables. *[7]*

Whether budgets are going up or down, managers leave the planning process with a clear understanding of their objectives, since their funding is linked to deliverables. This is the basis for individual accountability, since managers are expected to deliver the projects and services that were funded.

Footnotes

1. Meyer, N. Dean. *An Introduction to the Business-Within-a-Business Paradigm.* Ridgefield, CT: NDMA Publishing. 2002.

2. Stewart, G. Bennett. *The Quest for Value.* Collins Business. 1991.

3. Planning can be time consuming, but the investment can be managed. To be effective, business and financial planning processes must be enterprisewide. They must be comprehensive, considering all the resources of the firm. And they must involve every part of the organization to ensure coordination. The effort required should be managed by controlling depth, not breadth – for example, limiting management involvement to senior leaders, and controlling the granularity of intitiatives and operational services.

4. Meyer, N. Dean. "Investment-based Budgeting." White paper published by N. Dean Meyer and Associates Inc. 2008.

5. Meyer, N. Dean. *Full-cost Maturity Model.* Ridgefield, CT: NDMA Publishing. 2007, 2008.

6. A decision to fund an investment should be based on the total life-cycle cost, not just one year of funding as portrayed in the budget. Investment-based Budgeting is not a substitute for business proposals for each significant investment. Rather, it's a process for allocating budget in the coming fiscal year based on the investment decisions made throughout the year via such business proposals.

7. Meyer, N. Dean. *Downsizing Without Destroying: how to trim what your organization does rather than destroy its ability to do anything at all.* Ridgefield, CT: NDMA Publishing. 2008.

Sidebar: The Role of Software

NDMA offers the FullCost *[R]* software and planning process, and consulting services to train a leadership team while implementing Investment-based Budgeting.

The FullCost software can facilitate business and financial planning in a number of ways.

Planning/budgeting software captures managers' assumptions, and ensures financial transparency.

Planning/budgeting software also serves to structure the planning process. Managers learn to plan their businesses as they fill in the data, step by step.

Interestingly, software also helps to institutionalize the planning discipline. As new managers are promoted or hired, they learn the planning process in the course of learning to submit their budget requests through the software.

The product/service costing models built into planning/budgeting software take care of complex calculations. Planning/budgeting tools are more advanced than pure product-costing systems in that they don't require a known budget as input to amortize indirect costs or to forecast staffing requirements and compensation costs.

The required software is nothing like general-ledger applications that track and report actuals. Planning tools are highly interactive, and designed specifically to support each step of the planning process.

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