smh.com.au
The Sydney Morning Herald

BusinessDay

Identifying and resolving black holes

May 17, 2010

Don't operate in a vacuum or storm clouds will gather

Cutting edge Canadian research shows most business failures are not caused by external factors, but by 'black holes', areas of a business with dysfunctional characteristics.

In a black hole situation management doesn't really know what's going on in the organization, resulting in a vacuum effect, which can be fatal for the business as a whole. So how do black holes form, how can managers prevent them and what should you do if you find a black hole in your business?

Canadian author Ron Lutka is the author of a book called Black Holes in Organizations. According to Lutka a vacuum or black hole forms when there is a disconnect between management and the organization's basic actions and activities.

Lutka says "in days of old management was the best fisherman or hunter or farmer. But today management is usually not the best fisherman; management is nowhere near the basic actions and activities of the organization. This vacuum between management and the organization's basic actions allows irrational behaviour to enter the organization management cannot see to stomp out. The irrational thought can lead to failures in basic activities that in turn can cause or at least aggravate much larger problems higher up the organization."

Like their scientific cousins, corporate black holes are notoriously difficult to find. "Trying to find the absence of something is hard," says Jon Williams, partner, PricewaterhouseCoopers.

Williams says there are two categories of black holes. “Some black holes are permanent, ongoing situations as a result of technical incompetency, for example a lack of financial reporting skills.”

The other type, says Williams, results from employee uncertainty, for example when a company goes through a takeover. “People behave differently when they are uncertain compared to when they are confident. When people are uncertain they spend three times the effort protecting themselves rather than preparing for the future,” he says.

An example is a company in which staff are measured on how much client-facing work they complete. During uncertain times a staff member measured this way is likely to protect themselves by taking on as much client-facing work as possible, regardless of whether they have the skills to complete the work. This situation can easily lead to black holes.

Another catalyst for black holes is organizational complexity. According to Lutka “the more variables in the organization, for example in manufacturing businesses doing good volumes, the higher the likelihood of a black hole forming. Organizations with fewer variables but where actions and activities are repeated, such as in distribution businesses, can experience black holes if a few of these actions and activities fail.”

The consequences of black holes can be far ranging and include effects such as angry customers and suppliers, efficiency losses, low employee morale, narrowing margins, cash flow problems, confusion, lack of transparency, the organization’s loss of the ability to repair itself and, ultimately, corporate bankruptcy.

Lutka says the financial ramifications of black holes in organizations with which he has worked are serious. He says he has worked with Canadian firms where black holes have caused CAD$40 million in losses at one company and CAD$19 million in losses at another. “The $40 million write-off wiped out the life-to-date retained earnings of one public company,” he says.

Lutka says black holes are difficult and time-consuming to fix “because they operate below management’s radar and management cannot fix what management cannot see.” But it’s not impossible to get to the bottom of a black hole.

One company at which Lutka has successfully addressed a black hole is Canadian truck and engine firm Navistar Canada, which has sales in excess of CAD$1 billion annually. Corporate controller Andrew Ramsz says “like many organizations we didn’t recognize black holes existed. For years we believed our policies were adequate to guide anyone processing daily activities so that reports were accurate.”

But this belief was profoundly challenged when the company was forced to make a series of restatements covering a number of years. The company was required to restate fiscal years 2002 to 2004, through to the third quarter of 2005. “Fiscal year end 2005 was not reported. 2006, 2007, 2008 were reported later than required. This led to the US Securities and Exchange Commission delisting Navistar’s stock on the New York Stock Exchange,” Ramsz says.

Although at the time the situation was painful, the process of identifying vacuums within the organization has resulted in considerable improvements in the way the company is run.

“We were forced to recognize significant gaps due to ineffective controls, as well as a review process which was inadequate. Reconciliations were performed sporadically and only on select balance sheet accounts. The most critical black hole involved premature recognition of revenue,” says Ramsz.

Once it had identified its black holes Navistar took on a massive restatement project, hiring experts to help find and solve black hole issues.

“Using both internal and external resources we significantly reviewed our policies, which led to a strengthening of internal controls. Reporting was also changed so that we met compliance obligations. We also undertook a massive education program for the finance and accounting division to ensure channels of communication between functional areas opened,” Ramsz says.

Once the corrections were implemented Navistar’s reporting became more accurate and detailed. “Individual accountability for results is now reviewed and documented more stringently. We learnt it’s better to acknowledge black holes than think these holes do not exist in a tightly run operation,” he says.

It’s a lesson from which all managers can learn. Rather than operate in a vacuum, believing everything is right in the organization, it’s much better to take a critical view and a granular approach to assessing whether processes work. The consequences of not doing so can be serious and even fatal for a firm.

Key points

- Almost every business has black holes, or information vacuums
- The consequences are serious, even leading to total corporate failure
- It often takes a crisis to identify and resolve back holes in a business