



## The Five Minute MBA

# Open Books Management

## Get Your Employees Excited About Increasing Profit

### The Opportunity

Imagine this scenario. One of your hourly employees comes up to you and says, “I’m very concerned about our profitability. I’ve been reviewing the trends and I see gradual erosion of our gross margins due to price pressure in the marketplace and an unnerving upward movement of S, G & A costs which is putting pressure on our pre-tax margins. What steps is the management team taking to address the issues? By the way, I have some ideas on how we can lower our overhead.”

On the one hand you might feel that the last thing you need is all your employees looking over your shoulder at your financial performance. On the other hand, imagine having a company full of employees who really understood how business worked, really cared about the company’s profitability and had practical solutions to the problems.

Sound implausible? It’s not.

If you are reading this, you’ve probably heard or read about the open books approach somewhere. It is a very powerful way to run a company, but not necessarily quick or easy. Before we dig into the specifics, let’s look at the potential benefit.

First of all, most employees are dismally ignorant about business. Imagine walking the halls of any business and posing the following two questions to any employee you might meet:

“Tell me the difference between profit and cash, then tell me the difference between marketing and sales.” The probability of getting the correct answers is virtually zero. CEOs know the answers to these questions and even some senior managers (although remarkably few) know the answers, but when you consider how basic this knowledge is and that our employees don’t understand business even at this

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level is it any wonder that we struggle to get things done in business?

The specific objectives of open books are twofold: create community and turn employees into business people. The ultimate objective is to have all employees, shareholders, directors, and officers all pulling for the same thing: profitability and increased shareholder value.

To understand the notion of community, we need to go back to the father of open books, Michael Phillips. Back in the early 1970's, Phillips who was one of the developers of MasterCard, had put together a community of small business people in San Francisco called the Briar Patch to whom he consulted. One of his members, a small corner grocery store, of which there remain many in San Francisco neighborhoods, came to see him because they were losing money. Michael's advice was to hang their financial statements by the cash register every month.

After recovering from their shock, his client agreed and an interesting phenomenon began to take place. Customers would come in, take their purchase to the register and notice the financials hanging by the register. Being a relatively educated neighborhood, the customers knew what they were looking at. As everyone who knows financial statements does when they look at them, very quickly their eye moved to the bottom line. In this case the bottom line was negative.

Often this discovery would lead to a conversation and further exploration the financials. What began to happen is the customers found themselves confronted with the possibility of losing their corner store. Not wanting this to happen, the neighbors realized they needed to support their corner store more regularly in order to avoid losing it. Neighbors began talking with each other and more people started coming and looking at the financials, buying more bread, milk, coffee and making suggestions as to additional or different items they would buy if the store carried them.

This simple act of disclosure had a profound effect. It got the community involved in the business. It forced the customers to think about their relationship to the business. Doubtless there were some of the neighborhood residents that didn't particularly care that the store was in trouble. However, enough of them did and the information moved them from taking the store for granted to proactive involvement in the store's prosperity.

Internally in a company, opening the books can have a similar benefit. The act of opening the books is a highly symbolic act. It is a demonstration of commitment. It demonstrates trust. It demonstrates a commitment to treating employees like adults. It also engages a fundamental human need to feel associated with a winning team, a successful tribe.

Few CEOs or managers would describe their employees as businesspeople. They are employees, tasked to do specific jobs for which they are (hopefully) trained. How would business be different if all our employees understood how to think like businesspeople? Wouldn't they be scrutinizing costs, looking for ways to improve processes and eliminate wasteful activities? Wouldn't they be looking for ways to grow sales and gross margins? In fact they would, and will if you roll out open books properly.

It boils down to this: employees are expensive and getting more expensive every year. Are you maximizing your return on payroll?

One of the problems we have in business is that we've all been taught to think of payroll as an expense. It shows up on the income statement. We've never looked at payroll as an investment on which we should be looking for a return. If you change your perspective and look at payroll as an investment it

becomes apparent that there is enormous leverage. Think of it this way. If you invest in the bond market, your yield is controlled by the ups and downs of the market. If you invest in real estate, the same is true. Yes, you can clean up a piece of property and make it worth a bit more, but there is not a lot of opportunity to increase yields in most investments. It's mostly a matter of market timing.

Your investment on payroll is different. You are the one who primarily controls the value your employees bring to your company! By creating an environment that draws more attention, creativity and experience out of your employees, you get more value for your payroll dollar.

Sure it's logical, but does it work? Ask Jack Stack who took a sleepy diesel engine rebuilding division that International Harvester didn't want any more and after a leveraged buyout by his management team, trained all his employees in business starting with open books and built a \$250 million powerhouse business. There are many other examples. Some years ago at the Inc. 500 Conference held each year by Inc. Magazine to celebrate the 500 fastest growing private companies in the country, George Gendron, formerly editor-in-chief of Inc. Magazine asked the audience how many ran open books businesses. More than half the hands in the room went up.

This is no longer a radical idea. If you want employees to think and act like owners, you have to give them access to the information that owners have. Feedback is what changes human behavior. The financial statements are just one of many forms of feedback that business leaders rely on to help them calibrate on the right things to do.

Let's look at how open books gets implemented.

## **Steps**

Where to start? The key to open books is recognizing that you know much more than your employees do. You have to start slowly and educate everyone. Who should do all this educating? It depends. If you are a big enough business to have a Chief Financial Officer, he or she might be the right person. Your controller might be another option. If you have a large company with many hundreds of employees, your HR department will either have a training function, which may be able to provide the service. There are number of companies that provide accounting training for non-accounting employees. For the smaller company your accounting firm may be able to provide someone. Your local community college is likely to be another resource.

The keys to accounting training is to make it interesting and break the seminar into two or three sessions so employees don't go into overload. Remember a concept like depreciation as a non-cash expense may seem obvious to you, but may be a difficult and abstract concept to someone without the benefit of experience and/or formal training. Start with the income statement. It's the easiest: money in, money out. Even at that, you are likely to find that you'll want to do a session on just revenue and cost of goods. Then devote another session to sales, general and administrative expenses and profit. The balance sheet will likely take at least one session and possibly two: assets one day and liabilities and equity another. Eventually you will also want to expose your employees to the funds flow statement, but not until you've covered income statement and balance sheet.

One of the advantages of using in-house employees is that the material presented will be relevant to the participants' experience because the content will be about their company.

A question often raised is, “Do we show all employees *all* the numbers?” The answer is again, it depends. For a large company, the detailed financials are likely to be very complex. To begin with, keep it simple. Give employees the 30,000 foot view: major revenue categories, major cost of goods categories (e.g. material, direct labor) and lump the overhead expenses into categories that are broad enough to be understandable but still granular enough so that the numbers give a reasonably clear picture of the business.

There is a great line in the movie, *The Coal Miner’s Daughter*, the life story of country singer Loretta Lynn. At some point early in her career, Loretta’s husband calls her “stupid”. She turns around, gets in his face and says, “I may be ignorant but I ain’t stupid!” Remember, your employees may be ignorant, but they are not stupid.

If you ask one of your accounting staff to do the training, don’t assume that they know how to train. Training is a whole career in its own right and good trainers and good accountants often have very different personalities. If you are drawing on your own staff, get them help and support in putting together their training programs. There are many good training consultants who can help. Call your local chapter of the American Society for Training and Development (ASTD) and they will be able to refer you to competent people.

Another common question is, “What about showing salaries?” The answer to this is simple. Everyone may want to know what everyone else makes, but they don’t want anyone knowing what they make. Package your numbers to disguise individual salaries.

Another common question from the CEOs of closely held companies is, “The company pays for my car, my country club membership and some other completely legitimate deductible expenses. How do I show these things without making it look like I’m doing something unethical or that I’m milking the business?” What I have counseled in the past is for the CEO to put himself into the published financials as a “standard cost”. In other words, put in a cost that encompasses all compensation, cash and non-cash. Some years you may take more than that, some years less, but for the purposes of, for example, calculating profit sharing, employees will know that there is a number they can count on. In what form you take that compensation isn’t the employees’ business.

“When the employees see how much money I make, they’ll be furious and have their hands out for a piece of the pie!” This comment is also common. Here’s the ironic reality: It is virtually a given that your employees think you make much more money than you do! It almost always happens that employees are astonished to learn that for every dollar that floats into the front door, only a nickel, dime or fifteen cents is left at the end of the day. Very few employees have any notion that the average pretax margin for American businesses is something like seven percent.

That having been said, it may be that your business does much better than that. If that is the case, part of the financial training includes risk/reward, the foundation of financial capitalism. Entrepreneurs also tend to operate on the presumption that everyone is like them and driven to run their own show. The reality is clearly not the case. Most people have no desire for the risks and responsibilities of entrepreneurship. They recognize, by lowering their risk profile, they also lower their reward profile and are comfortable with that.

On the other hand, if you have been using closed books to mask inequities in compensation or not compensating your employees at or near market rates or other practices of questionable ethics, opening

the books will sooner or later bring these practices to light. You may not publish the specific numbers, but your employees will do their homework and infer more from the numbers than you might expect.

Another point to remember is that the financials are not the only numbers that matter. In fact, in many cases, they are the least useful.

Think of it this way. When the books close at the end of the month, it takes a couple of weeks typically for accounting to reconcile the bank statements, tie up the loose ends and publish the financials. That means the information is anywhere from two to six weeks old.

Further, particularly on the revenue side, the activities that went into creating that revenue (marketing, sales, proposal writing and so on) may have begun eighteen to twenty-four months before that in many business-to-business companies. So the financials are what I would call “lagging indicators”. From a management standpoint, because they are so far behind the reality from a time standpoint, they aren’t that useful operationally.

Much more useful are the “leading indicators”. Examples would be, number of sales calls made, number of completed phone conversations with prospects, number of meetings with prospects, number of RFQs (requests for proposals) number of closed deals. In every industry, the measures will be a bit different. These numbers, however are the numbers that will determine what revenue shows up in the future. When you know how these numbers should look and if they are drifting away from their defined targets, you can intervene quickly to get things back on track. This kind of feedback will have a much more immediate and dramatic impact of financial performance.

The point is your employees need to be trained on key indicators for every department as well, particularly the leading indicators so that everyone is paying attention to them. These are the measures that will determine your future success.

### **Be Aware of Some Issues**

Open books management is not a quick fix for anything. You will have to invest time, possibly in outside expertise not just to get your employees up to speed, but to provide ongoing information, answering questions, helping them gain deeper understanding of how businesses actually work. If you are in crisis mode, this is probably not the time to launch such an initiative. Better to get on your feet. That having been said, there may be times where laying the financial realities out on the table might well be the perfect strategy to mobilize your people and get back in the game. Like any other business decision, careful thought, practicality, prudence need to be your guides.

You will discover quickly when you launch an open books initiative how big the gap is between what leaders and senior managers know and what their lower level employees know. You will begin to realize the level of effort it will take to close that gap. Be patient but get started. Remember that the potential competitive advantages you will gain by getting *all* of the brains you are paying for in the game will be huge. Moreover, in the two to three years it will take to fully establish an open-books culture, once your competitors realize what you’ve done and how and undertake to follow you, you will have a huge lead they will find almost impossible to close.

Not everyone will get with the program. When you as a leader put a stake in the ground, any stake, it creates a polarizing effect. You force people to ask themselves, do I want to be on this train or not. Some will say, “I don’t like this direction” and leave. Others will pay lip service to it but you will see over

time that they are not really engaged and you will have to call them out to engage or leave. Others will be skeptical and take a wait and see attitude. These people will often become your staunchest supporters when they see the value in what you're doing. Others will just get it from the beginning.

It is worth remembering that buy-in is essential for management but largely irrelevant to leadership. Being a leader means making decisions and letting your followers decide if they want to come along. It really doesn't matter that some will adapt into your vision and others will adapt out. Those who leave create openings you can fill with more like-minded, progressive people who are excited by your vision of what's possible. There is no payoff in dragging a bunch of dead horses around. You need horses that are excited and ready to run.

The point is that implementing any fundamental cultural change like open books takes courage, the willingness to jettison some people who may be seen as indispensable. It takes commitment to get up the learning curve and lead the way even when you don't know yourself exactly where "the way" is. It takes humility and a willingness to learn. You will learn things from your employees in ways that you might never anticipate. And it takes trust in the underlying belief that our employees are adults, are worth trusting, and that they are able and more than willing to contribute far more to your organization than traditional management practice has asked or expected of them.

### **Actions**

1. If open books management sounds interesting to you and you want to look into it more seriously, then you would do well to do some additional reading.

For smaller companies, *Honest Business* by Michael Phillips and Salli Rasberry is worth a read. Written in the early 80's it is a compendium of common sense wisdom on running small businesses. The current edition is a pocket, abridged edition by Shambala, but I would recommend looking for the original out of print edition by Random House.

Two books that illustrate what can happen when you give employees tools and get out of their way are: *The Great Game of Business* by Jack Stack and *Flight of the Buffalo* by Ralph Stayer and James Belasco which are both classics. Stack's book focuses especially on open books and employee stock ownership.

Two additional excellent resources specifically focused on open books are *Open Books Management* and *The Open Books Experience* both by John Case.

2. Plan the transition with as much care as you would the relocation of an office or plant. Think through the process, line up your training resources, and assess how quickly you can roll the process out.
3. Plan your own time commitment to the process. If you are the leader of your organization, everyone is taking his or her cue from you. If you are actively involved, sharing the teaching load, reviewing the numbers with rank and file employees every month, the process will be taken seriously by them. If you are nowhere to be seen in the process, at best, people will take a wait and see attitude and at worst be cynical and resistant.

4. Assume it will take two to three years to fully assimilate into the culture of your company because it will take that long to get to a place where watching and responding to the numbers is as much of everyone's daily routine as their morning cup of coffee.

## **Conclusion**

Open books is a powerful methodology of increasing your return on payroll, creating a company designed to fully draw out and leverage the total talent, intelligence, creativity, knowledge, experience, energy and enthusiasm of your people.

If this work is of interest to you, you should be aware that open books is just one component of a comprehensive system for creating companies that require little or no management in the traditional sense. You can learn more about designing self-managing companies by visiting <http://www.TheEndofManagement.com>.

## **About Lanny Goodman**

Since 1980, CEOs of companies large and small have consulted with Lanny around their strategic planning processes. Primarily focused on entrepreneurial organizations, Lanny's planning methodologies help companies focus their efforts, improve profitability, rationalize their operations and leverage their people.

In the late 1980's Lanny began exploring how changes in our understanding how the universe works might apply to how we lead and manage companies. Building on the principles of the new science of complexity theory, Lanny spent fifteen years working with his clients, researching and experimenting to create the first comprehensive system for creating companies that run themselves. Lanny's book, *The End of Management* lays out the logic of self-managing systems. His company, Management Technologies Inc. provides comprehensive support services to organizations interested in creating companies built from the ground up to fully leverage their people. For more information visit [www.managementtech.com](http://www.managementtech.com).

Lanny's work has been the subject of a feature article in Inc. Magazine. He has been quoted there extensively as well as in Fortune Small Business and the New York Times. Lanny has spoken at sixteen Inc. Magazine national conferences including five Inc. 500 conferences, celebrating the 500 fastest growing private companies in the country.

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Thanks for your interest in the Five Minute MBA.