

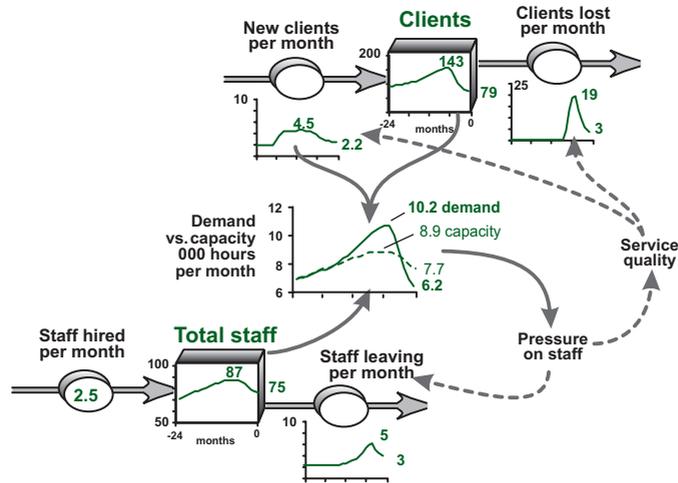
## INTANGIBLES CONCERNING STATE OF MIND

Intangible resources reflecting the state of mind of key groups can be illustrated by the case of a computer support firm that provides assistance and advice to small and medium sized enterprises (SMEs). It recommends choices of hardware and software, installs these for clients, and provides continuing maintenance, support, upgrades and training. Two years before the time in question, the company served some 90 clients who required about 75 hours per month of service. Its founder and CEO was signing up just under two new clients per month, and none were leaving. Each new client also needed about 200 hours of initial work to get them set up on a sound basis. The company was delivering good service to its clients, and had a solid reputation that helped the CEO sign up more new clients.

The staffing situation two years before the study had seen the company employing 70 technical staff, of whom 15 were relatively new. It was taking on two or three new people per month to cope with growing demand, and losing only about one person per month. Experienced staff had 120 hours per month available to serve clients, after allowing for administrative tasks, holidays, and so on. New staff were not so effective, taking about three times as long as experienced people to do typical tasks. In addition, each new staff member needed about 10 hours per month of supervisory time from an experienced employee. It took three months for new staff to become fully productive, though initially only on a limited range of tasks. Staff morale back then had been high, reflecting the company's stable situation and the interesting variety of work. Staff had been busy, but not overloaded, having to work at about 95 % of their top rate to ensure good client service.

About 18 months previously, the CEO found himself needing to spend too much time managing the growing operations of the business, to continue his selling efforts, so brought in an experienced business development executive to take on the task of winning new customers. With the company's strong reputation, the efforts of this new executive were successful and soon he was bringing in about five new clients per month instead of two (see Figure 9.2). Work and sales streamed in, and all seemed well until about nine months later. Staff were increasingly busy, and the CEO noticed from the payroll information that on average they were putting in 15 % more time than normal. There had also been an increase in complaints from clients about service quality.

Then after a further three months, that is six months before the time of the study, things really started to fall apart. Staff pressure got still worse, although numbers



**Figure 9.2: Growth and decline at a computer service provider (dashed lines = incomplete causality).**

had grown to 87, and complaints from the clients, by now numbering 143, escalated sharply. For the first time, some clients actually left the business to find service support from other providers, and the business development executive was having less success in bringing in new clients to replace them. Still worse, staff were starting to leave more quickly than ever before, apparently due to the pressure they were under. Over the latest few months, clients and staff both left in increasing numbers, and the new client win rate more than halved.

By the time of the study, client numbers had fallen to only 79, staff losses had cut their numbers to just 75, and the few new clients being won were more than matched by continuing departures. The only good news was that customer complaints were down and staff did not seem to be so overloaded. In fact, the work logs suggested that they were only 80% utilized.

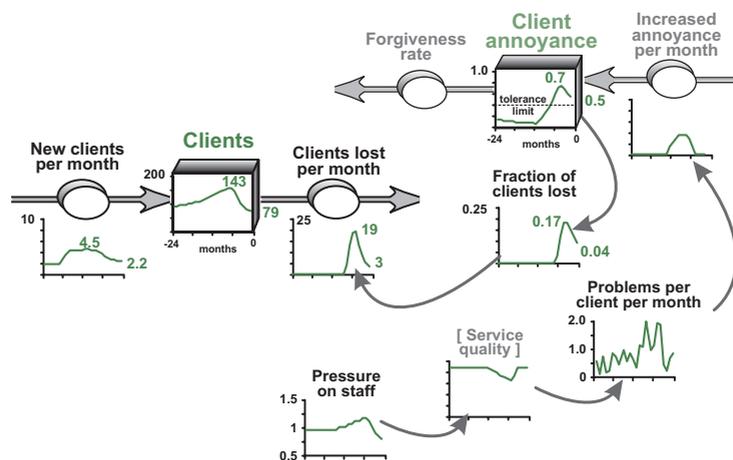
The story is rather simple to explain, and clearly reflects some problems with the organization's intangibles—work pressure rising, and service quality falling—leading to loss of staff and clients respectively. But this generalized statement of what caused what is not sufficient for our purpose. We need to know not only why things happened, but why they happened *to that degree* and *on that timescale*. Without that understanding, it is not possible to know by how much the organization should have acted to avert the problem. Nor is it possible to know what to do when and how much, to put the organization back on a strong path. Avoiding a repeat of the problem is easy—don't chase business again—but that will leave the

business way short of the potential it could achieve if it put in place procedures for ensuring reliable growth.

Probing deeper into the story, some puzzles become apparent. For instance, staff were overloaded from month  $-15$ , so why was it not until month  $-9$  that customers started complaining? Then why was it a further few months before clients actually left? And why did staff losses only pick up some three months after the overload started, and grow only slowly over the next few months? Next, if the worst point reached was an overload of about 20%, how come the firm subsequently lost nearly half of its clients? This number clearly matters a great deal, not only because it implies that revenue nearly halved, threatening to hit profitability badly, but also because management needs to know what their staffing plans should be.

The difficulty in answering these questions arises for several reasons. First, the intangibles involved are exactly that—difficult to touch or see, and therefore hard to measure. Next, even if the intangibles were known with complete accuracy, the impact they have on the tangible resources of clients and staff cannot be known with any certainty. Some of the intangibles accumulate, that is they build up over time, and may also drain away. And it is difficult to know how quickly these processes are happening. Lastly, there may be threshold effects, where nothing appears to go wrong until a problem has built up to a level that triggers a sudden change.

Figure 9.3 pulls apart just one of the mechanisms operating in this case. Starting from the bottom of the diagram the staff are just able to sustain good service quality until the pressure gets too high—pressure defined as the ratio between the



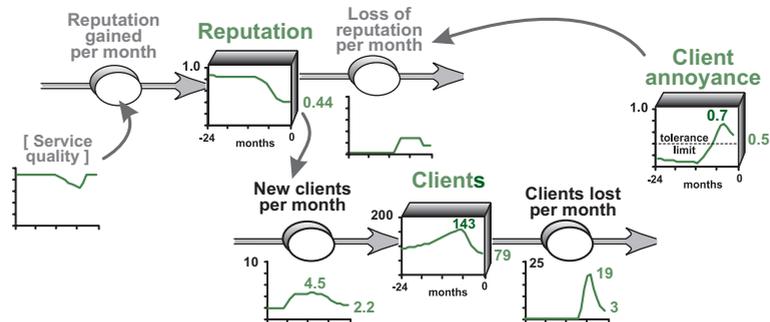
**Figure 9.3:** Staff pressure hits service quality, annoys clients and causes some to leave.

amount of work to be done and the capacity of staff to do the work. Service quality then falls. This is not easily observed or measured, consisting as it does of various issues, from delays in answering the phone, to incorrect advice to users, to faulty installations. But one measure is the number of problems reported by customers. This is not a nice smooth data series, but fluctuates substantially from month to month. Nevertheless, there was clearly an increase in the problem rate during the time that staff pressure escalated.

The section at the top of Figure 9.3 is quite invisible to management, but is a reasonable description of what is going on. Every problem incident makes the client who experienced it just a little more annoyed with the service provider than they were before. Few such firms can promise never to make any kind of mistake, but the problems in the early months happen so seldom that the last one is forgotten or forgiven before the next arises. The more frequently failures occur, the more customers' annoyance builds up, and now this is not forgiven before the next problem occurs. (This will be a familiar feeling for consumers in many markets, such as air travel and banking).

It is at this point that an important threshold effect occurs. Switching to a new service provider is risky. Clients cannot be sure that another provider will give better service, and there may be some inconvenience—searching for, assessing and briefing another supplier will take time and effort. Consequently, annoyance must build up to some significant level before it triggers clients to leave. This is why some five to six months elapse between service quality starting to cause clients increasing problems and the first clients actually leaving. By this time, annoyance is so high and so widespread amongst clients that it is not just a few who leave, but a large fraction every month. This explains why the total losses are so great. Note also that losses continue long after the time that service quality recovers and the reported rate of problems drops back. For an already-angry customer, even a small additional problem may be enough to tip them over the edge. The dominant consequence of client annoyance, then, is that it triggers a catastrophic episode of customer losses.<sup>11</sup>

The quantification in Figure 9.3 suggests a degree of exactness in the causality that would be hard to confirm in reality. The use of lighter outlines and gray text acknowledges the somewhat approximate nature of the intangible factors. However, the phenomena it portrays are very real. The clients must have left for *some* reason, and it is entirely likely that, had they been asked at the time why they were leaving, they would have answered “Because I am very annoyed with this supplier.” Asked why *that* was, we would be pretty certain to get the answer “Because I have had more and more problems over many months.” The number of problems reported is not speculative at all, but actual data. And though the figure shows service quality as an unknown variable, many organizations in fact measure this item in some detail.



**Figure 9.4:** Annoyance amongst clients damages reputation, and cuts the client win rate.

Of course, it is not possible to know all of these items accurately. It is difficult, for example, to find out just how “annoyed” clients actually are—at least not without making them even more so! Nor can we be certain what level of annoyance will trigger their decision to leave. But difficulty of measurement does not refute the likelihood that this is what is happening.

Figure 9.4 expands on a further part of the system, and examines why the business development executive found increasing difficulty in winning new clients for the firm. Current customers talk to other people, and organizations needing service ask others about their experiences. Until about month  $-15$ , those conversations were largely positive. Continuous experience of good service quality by existing clients led them to sustain the firm’s reputation. More recently, the increasing annoyance amongst clients caused them to undermine this reputation—“Well I have had really bad problems with this firm recently, so I could not possibly recommend you to use them.” It takes time for this reputation to spread, so note that it has barely started to recover by the end of the period, even though the actual service quality has been OK for some time.

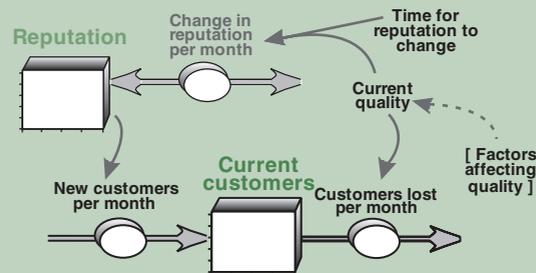
The practical consequences are clear. When reputation was high, the business development executive was successful with nearly all his approaches to new clients. As reputation fell, most of those organizations he approached refused, citing the bad things they had heard about the firm’s service.

Once again, the quantification shown here is not knowable with any precision, but reflects answers that might be given if potential clients in the region were asked “What have you heard about how people rate this firm for service?” It is important to note that they do not have any direct experience of service themselves, so cannot be directly influenced by that factor. In other cases, current service quality may be

made public, for example by various research agencies, but even then it is more likely to report client's recent experiences with some delay, rather than current reality.

### Quality and reputation: a common structure

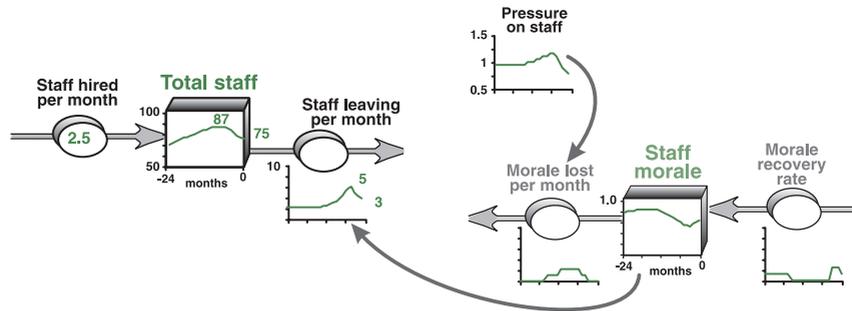
The connection between quality and reputation implied by Figures 9.3 and 9.4 turns out to be extremely widespread. The common principle that it reflects is that “quality affects current customers: reputation affects potential customers” (see Figure 9.5). It is important to note that active and potential customers are different groups, and that our concern is with different behaviors from each group—we want potential customers to join us, and we want active customers to stay with us and buy more from us.



**Figure 9.5:** A widespread relationship between quality, reputation and customer movements.

The reason this structure is so common is that current customers have direct experience of current quality factors, at least to the degree determined by the frequency with which they transact with the supplier. Potential customers, on the other hand, have no such direct experience, so can only go on what they hear indirectly about quality. The speed with which reputation changes depends on various factors. It may be fast if, for example, research organizations assess the views of current customers frequently and in detail, but will be slow if word is spread only by infrequent contact between current and potential customers.

Similar mechanisms operate in the case of employees who know first-hand what it is like to work for an employer, and prospective employees who can only go on what they come to believe from speaking to others.



**Figure 9.6:** Pressure on staff undermines morale, raising the rate people leave.

The last piece of this story to explain is the behavior of the staff (Figure 9.6). Once again, there is no immediate link from the underlying cause—pressure on staff—to the rate at which people leave. Instead, it has to go through a process that changes their state of mind. Initially, with work and service demand more or less in balance, people are busy but not over-stressed and morale continues to strengthen. Increasing work pressure then damages morale, but this is a gradual process; overwork is at first tolerable, but the longer it goes on, and the more heavily overloaded people are, the more the stock of morale is drained. The lower morale becomes, the larger the fraction of staff who leave each month. There could again be a trigger level similar to that which drives clients away—“I have put up with the stress for long enough, so I’m off.”—but some staff turnover is normal as people find other opportunities or just move on in their lives. The declining morale just accelerates this process.

### **An unthinkable strategy response: stop selling!**

An apparently obvious response for this firm, once the service quality problems start, is to hire more staff. Unfortunately, this just will not work—at least not fast enough. It takes time for established staff to interview and select new people, and then support them once they have arrived. The last thing overstressed professionals need is the extra burden of hiring and training newcomers.

Given that the firm can’t boost the supply side of its business, there is only one other alternative—cut the demand side. At one level, this implies a stop to

new selling efforts; at a more serious level it may even mean dropping existing customers. This of course is utterly unthinkable! When business is in trouble, surely the last thing you need is to stop selling? And surely you would be mad to cut customers off when in such trouble.

Remarkably, there are situations when both of these responses are exactly what should be done. In this case, the sales message is implicitly “Come join us, so we can do a really bad job for you,” and that is not a message anyone would want to give. Even dropping customers could be useful. As explained in Chapter 5, some customers will contribute little profitability, and they or others will demand disproportionate amounts of support.

It is now axiomatic that keeping existing customers is much easier than winning new ones, but this is not necessarily the case when existing customers know how badly you are doing, and new ones do not. Also, the slogan “It costs X times more to win a customer than to keep one” is meaningless—keeping a customer has to be done continually, whereas winning one is a one-off event.

So—if service quality is a problem and supply cannot be quickly raised, cutting demand may well be advisable.

(Online learning materials are available to support this example, see p.xxi.)

As with the reputation issue above, the level of morale is in principle researchable. Indeed many organizations carry out morale surveys as a matter of course. Rarely, though, do they check on staff feelings often enough to detect the kinds of changes shown in this case. This may not be necessary, when skilled team leaders and managers take trouble to keep themselves well in touch with how their people are feeling. However, this is not always the case, so it is often helpful, especially in larger organizations, to have systems in place for tracking this important issue.

This company’s experience demonstrates some common features of how psychological intangibles feature in the strategic performance of organizations:

- *State of mind drives behavior.* The fact that clients left this company because of their annoyance, that others did not join because of the impressions they had gained from others and that staff left more quickly because of their low morale are simple examples of a very widespread phenomenon—people act because of how they feel. This is hardly news to the field of psychology, but we are making explicit the link between some simple measures of how people feel and the rate

at which they exhibit behaviors that are important to how the wider business system performs. Extremely detailed and tightly controlled experimentation is of course required for scientific proof of these links, exactly how they work, and how they relate to other influences. But this framework is adequate for a high-level understanding of what is happening.

- *Intangibles have considerable influence.* The performance of the case above is not merely *somewhat* influenced by the intangibles involved; it is *heavily* determined by them. There is no possibility whatever of explaining the outcome without taking account of those issues. Equally, had the client growth initiative not been started, the outcomes would have been radically different, not just marginally better. Well known cases in the public domain also illustrate this principle. Amongst the most dramatic of these is the total collapse in 2002 of accounting firm Arthur Andersen, following its involvement in the demise of Enron Inc.<sup>12</sup> On a more positive note, there is evidence that strong reputation can show up in real business value.<sup>13</sup>
- *Intangibles are influenced by, as well as influencing the tangible system.* The problems here are not caused by staff disrespecting the clients, by management failing to promote a good reputation for the firm, or by leaders behaving unreasonably towards their staff. They are caused by the simple physics of the relationships between the tangible factors involved; client numbers, staff, workload and capacity. If those negative behaviors were to occur, of course, they would also cause problems, but they are not the explanation here, nor in many real situations. People are doing their best, but poor strategy makes it impossible to do well.
- *Intangibles are manageable.* A senior partner in one of the major strategy consulting firms once remarked that their firm's work for clients ignored intangibles because they are undetectable, unmeasurable and unmanageable. All three of these assertions are untrue. Sales people can certainly detect when customers are annoyed, and managers know when their staff are unhappy. These and other intangible factors can be measured, and often are. Finally, skilled managers in all kinds of situations work successfully to turn round low morale in teams and whole organizations, and can drive high levels of commitment and motivation. Chapter 6 mentioned the case of the bank whose detection of "miserable moments" experienced by their customers was matched to a deliberate policy of giving them "magic moments" in order to reset their feelings of annoyance. Intangibles are also manageable indirectly by acting to fix the tangible system that is driving them.
- *Managing the system can manage intangibles.* The problems above were created by management, and could be fixed by them. Had the organization not attempted

to increase its growth in the first place, but continued on the sound trajectory with which it started, it would have ended with about 130 very happy clients, and some 80 contented staff. Even after the problem started, the situation could have been rescued. Had the firm stopped chasing new clients as soon as the work overload hit 10 %, the growth in staff coming through the system would have brought down the client problems. After a few months, more cautious growth could have been resumed. The firm could even have made it possible to cope with the growth it sought, had it raised its hiring rate some months prior to taking on the business development executive.

- *Problems “fix themselves”*—though not necessarily as we would like. In Figure 9.3, most of the problems have disappeared by the time of the study. Workload and client service are no longer at critical levels, client annoyance is dropping, staff morale is recovering, and even reputation will start to build again once clients have experienced good service for some months. The problem is, the medicine that fixed the problem is very unpleasant—a 45 % drop in business! Chapter 4 introduced the idea of feedback amongst resources and explained how balancing feedback can obstruct growth. This explains what is happening in this case, where the mechanism that brings things back into balance is the departure of unhappy clients.
- *Persistent bad performance.* Though not shown in this case, this self-fixing of the problem can readily become a persistent state. We win more customers than we can handle, so serve them badly, so they leave, to be replaced with more new customers we will disappoint. Given the sometimes obsessive concern with improved efficiency, this phenomenon of organizations seeking growth they cannot serve, only to be continually disappointed that it is not sustained appears to be widespread. To prevent such chronic difficulty requires some degree of organizational “slack”—a little more capacity than you strictly need, just to make sure it never becomes a constraint. If concerned at the costly inefficiency of such a policy, it is worth recalling the reasoning offered at the start of Chapter 1. Would you prefer to make a return on sales of 15 % and for ever struggle to cope, or make 12 % and be able to develop strongly?
- *Negative factors vs. absences of positives.* Not all of peoples’ feelings are positive. As shown in this case, annoyance is a realistic description of customers’ state of mind that drives behavior that we would prefer did not occur. It is quite different from the absence of a positive emotion, such as “customer satisfaction,” which may result in indifference but not explicit hostility.
- *Thresholds and tipping points.* This case again shows the problems caused when factors move towards a threshold that triggers new behavior. As explained in

chapter 4, the resulting tipping point is not caused by feedback, but simply by the crossing of two lines. Here, service quality is fine until pressure of work exceeds what the staff can do well, and clients do not actually leave until annoyance crosses their tolerance limit. The impact of morale on staff turnover is less clear-cut, but is nevertheless highly non-linear in its behavior.

- *When success on the balanced scorecard is really failure.* During the early months of this episode, management may reasonably have been pleased with their success. Not only did client numbers grow more strongly for at least six months, but productivity reached new high levels, as a result of which profitability on the growing revenues would have been outstanding. Had these measures all appeared on the firm's balanced scorecard, green lights would have been flashing continuously. However, the reality would have been that high staff utilization should have been flashing a *negatived* red, and even the high client win rate should have been highlighted as a problem, not a success. In spite of the unavoidable implications of these observations, balanced scorecards rarely highlight high rates of sales success as a problem!

## INTANGIBLE FACTORS VS. INTANGIBLE RESOURCES

This situation above features several intangible factors: work pressure, service quality, client annoyance, reputation and staff morale. But not all of these are resources; that is, accumulating stocks. The telling feature that marks out those non-resource items is whether they could feasibly be instantly fixed. Work pressure would instantly drop if work demand fell, and in this case service quality would instantly recover if work pressure were to drop. Neither of these items, then, can be resources. There can be cases where quality shows resource-like behavior, for example in manufactured products where an intangible stock of problems that damage quality must be worked away over some time. But that is not the case here.

## MEASURES FOR STATE-OF-MIND INTANGIBLES

If intangible resources concerning the state of mind of important groups is to be useful in assessing and managing strategic performance, it will be necessary to find measures for them that are reliable. A full exploration of research methods is beyond the scope of this discussion, but since the aim is to understand how strongly people are feeling on an issue, scales that in some way indicate a range from “empty” to “full” will often be appropriate. A common example is the Likert scale, which seeks ratings on (usually) a 5-point scale from “strongly disagree” to “strongly agree.”<sup>14</sup>

**TABLE 9.1: EXAMPLES OF PSYCHOLOGICAL INTANGIBLE RESOURCES**

<b>State-of-mind intangible resources</b>	<b>Measure</b>	<b>Resource flows that may be affected</b>
Satisfaction level	<b>0–1.0</b>	Customer purchase rate
Annoyance level	<b>0–1.0</b>	Customer loss rate
Reputation	<b>0–1.0</b>	Customer acquisition rate
Morale	<b>0–1.0</b>	Work rate Attrition rate
Investor confidence	<b>0–1.0</b>	Additional finance raised

For the purpose of assessing dynamically how the factors that drive changes in feelings operate, it is useful to adopt a zero-to-one scale, where zero implies no feeling and 1.0 implies the strongest possible feeling. This approach is useful when assessing dynamics because it is self-balancing at both ends of the scale—if there is little feeling in place, then there is little that can happen to reduce that feeling still further; if the feeling is nearly full, then there is little potential to add any more to that emotion (Table 9.1). It also allows the factors that depend on the intangible to be “looked up” in a consistent manner. How hard will staff work, for example, if their morale is at the highest possible level, or how quickly will customers leave if their annoyance is at a level of 0.5?

### **Think of neurones firing**

An imaginary device may help picture how state-of-mind factors such as those shown in this section are working. Imagine you could peer inside people’s brains and actually count how many neurones are firing off instructions, such as “look for a new job” or “fire that supplier.” Whilst all is well, those neurones are largely quiet, not urging the brain’s owner to do anything at all. When something bad happens, some of those neurones start firing away, but others are also at work, telling the person not to act—maybe due to the employee having been well-treated, or that supplier having done well in the past. If nothing bad happens

for a time, a fraction of those neurones urging action will quiet down, and the longer the period of no bad news, the fewer neurones continue to fire away.

The more frequently bad experiences arrive however, and the more serious they are, the more neurones can be seen firing off instructions to act. If this goes on long enough, the number urging action outnumber those urging inaction, and the person makes their move. Some of our efforts are aimed at preventing the events that start this negative brain activity, while others aim, almost literally, to calm it down.

A similar analogy may help visualize positive states of mind, only this time we are trying to get neurones firing that urge their owner to work harder or to recommend a product to friends. For both positive and negative states of mind, there is a limit to just how strongly we can feel about a wide range of issues—we can't stay angry about everything bad that ever happened, or enthusiastic about everything good. So it is only to be expected that both kinds of feeling fade away over time unless stimulated once more.

## REPUTATION, PERCEPTIONS AND THE VALUE CURVE

In Figure 9.4, the computer service organization was only able to win new clients if its reputation for good service was strong. As noted earlier, that reputation is a *perception* amongst potential clients, rather than the reality of the service currently being experienced by active customers. In other cases, several perceptions may be involved in the decisions made by customers, staff or other groups. Few cases show this more dramatically than do luxury brands, most of which have no functional superiority over a large number of equivalent products, but nevertheless enjoy a perception amongst many consumers as to their desirability. The expected admiration of others that this group expects to gain by being seen with the branded item is enough to persuade them to seek the product out and to pay more—often many times more—than they would for perfectly functional alternatives.

Business-to-business marketing and sales situations exhibit similar perceptual biases, though rarely on a similar scale. The phrase “nobody got fired for buying IBM” dates back decades to a time when the company dominated the market for large corporate computer systems, and reflected the perception that the company's products and service were substantially superior to those of competitors. However, the people responsible for recommending large IT investments rarely had any objective evidence as to the true reliability of competing suppliers. Even where such information was available for specific pieces of equipment, this might not be