The Risk of the Single Metric

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Over the past several decades the number of metrics used to measure a company's worth have narrowed to one: profit. The formula is simple

Profit = Excellence

You can find this simple construct in everything from the bombastic pronouncements of Donald Trump to the harangues of Jim Cramer. While these people may not represent the more thoughtful among us, make no mistake; their views on what constitutes excellence are widely accepted. The problem is that the formula makes no sense from a factual perspective and creates tremendous problems in assessing risk.

Excellence creates many things such as creativity, cooperation, inspiration, collaboration and so forth. Profit is a secondary or tertiary result of excellence, not the other way around. Profit is an outcome, not a strategy. Attempts to make it a strategy usually result in some pretty bizarre behavior on the part of corporate managers and employees.

Risk management, in the context of this erroneous formula has become an exercise in attempting to determine how much profit might be affected by a negative event. Corporations seem insistent on this approach regardless of the consistent and increasingly dramatic evidence that it doesn't work and, at best provides a false sense of security.

But there is a drumbeat for change. What follows is an analysis that began over a decade ago. While the information isn't new, there is some evidence that the perception that profit as a strategy no longer has utility.

A 2004 study in Business Week magazine provides us with a comparison between a company that attempts to achieve profit at any cost (Wall-Mart) versus a company that fosters excellence in its workforce (Costco). The results are dramatic although the first table seems to indicate that Wal-Mart is running a tighter, more cost effective organization.

	Costco	**Wal-Mart/SMS CLUB**
Average Hourly Wage	$15.97	$11.52*
Annual Health Costs per Worker	$5,735	$3,5000
Covered by Health Plan	82%	47%
Annual retirement costs per worker	$1,330	$747
Covered by retirement plans	91%**	64%

*Excludes part-time workers **Workers less than a year not covered

The second table demonstrates the result of the Wal-Mart profit strategy versus the Costco investment in excellence strategy. By paying its workers a living wage, providing them with healthcare and a retirement plan that will actually allow them to retire, Costco is reaping significant benefits.

	Costco	**Wal-Mart/SMS CLUB**
Employee turnover	6%	21%
Labor and overhead costs	9.8%	17%*
Sales per square foot	$795	$516
Profits per employee	$13,647	$11,039
Yearly operating-income growth**	10.1%	9.8%

*For all of Wal-Mart **Over the past five years in the US

The distance between Costco and Wal-Mart's approach has remained consistent, as have the results. In an October, 2011 analysis written by Jeff Reeves, Editor of Investorplace.com provides clear evidence that Costco continues to thrive with revenues up nearly 30% in the past year while Wal-Mart experienced it's 9th consecutive quarter of declining sales as of August of 2011.

What does this have to do with risk management? Everything. When an organization focuses on excellence it galvanizes its workforce, not only by providing them with financial incentives but, more importantly, creating an environment where they take initiative to achieve the company's goals. The alternative approach, treating employees as drones and translating the balance sheet idea that they are an expense to be minimized results in less, not more profit.

But the disparity between the two approaches is actually more insidious. Statistics compiled from a variety of sources show that 75% of all employees have stolen from their companies. That amounts to the loss of $50 billion and 7% of annual revenues. Those are huge numbers. Not surprisingly, a study done by Chen and Sandino at the University of Illinois clearly shows that there is a direct correlation between lower wages and greater theft.

Costco's employee theft is 1/10 of the industry average. The statistics don't end here but they consistently demonstrate that how people feel about where they work is fundamental to how they perform. Organizations not only suffer less theft, they also benefit in ways that are more difficult to measure. When someone feels good about their environment they are much more likely to defend it against individuals who behave in a way that could harm it. Back in the days before risk management was a profession, companies relied on the loyalty of their workers as the primary guard against damage to their reputations and their bottom lines. The comparison between Wal-Mart and Costco clearly demonstrates the folly of moving away from this idea and embracing a set of abstract numbers to guide an organization's decision-making process.

The perception of risk is based on emotion. Apple's recent decision to bring some of it's manufacturing back to the US is clearly a reaction to the deplorable conditions at the Foxccon factory in China that resulted in a number of suicides. Apple understands that its brand cannot survive that kind of damage. Wal-Mart, on the other hand seems to embrace its reputation as an organization that only pays lip service to providing employees with reasonable compensation and benefits.

Ask yourself who has the greater risk.