

Business Strategy the IKA Way™

**New ideas for creating profits
that will change the way you
think about your business**



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Business Strategy the IKA Way™ creates new profits from Information, Knowledge and Action. Many executives forgo profits from information and knowledge. That's because their strategies are based on out of date economics. They can't tie information and knowledge to the bottom line. Business Strategy the IKA Way™ synthesizes Nobel prize-winning advances in information economics, signal processing and strategy theory. It shows executives how to exploit, create and protect valuable advantages in Information, Knowledge and Action. With Business Strategy the IKA Way™ executives seize new profits ignored by traditional business strategies, exploit the strategic potential of marketing and sales and obliterate the barrier between strategy and implementation.

What Information Would Most Increase Your Profits?

Information is valuable, but most executives can't say how it hits the bottom line. Consequently, they rarely think strategically about information. Many confuse information with information technology. These executives are missing a vital source of profits, and may even be putting their businesses at risk. For something of such importance, "information" is conspicuously absent from business strategies. That's because strategy tools are based on out of date economics. Strategists make two mistakes: they underestimate the economic impact of information and they confuse information with knowledge. Two recent Nobel prizes exposed these flaws.

Two Common Mistakes and Two Nobel Prizes

Underestimating the Impact of Information

Many strategists ignore information flow between a firm and its customers. Some assume that the only competitive advantage from information comes from low transaction costs. Others ignore information because its value is hard to determine, changes with time, and can go to zero. Many strategists believe information advantages are unsustainable. And some economists say that information is not important because markets are efficient.

Experienced executives doubt these assertions, and the 2001 Nobel Prize in economics explains why. Information is not just a cost; it is fundamentally different from other factors. When one party to a transaction has better information than the other one, the market has *asymmetric information*. The Nobel-winning analysis shows that the impact of asymmetric information can be enormous, causing dramatic price changes or even complete market failure. To quote one prizewinner, “even small information costs can have large consequences”¹. In the real world, markets with asymmetric information are everywhere. Executives can create large returns from small investments in information asymmetries. Yet traditional strategies ignore these profit opportunities.

Confusing Information and Knowledge

Strategists assume that firms react predictably to information. Economists call this the “rational behavior” assumption. Unfortunately, it ignores learning completely.

Executives understand that firms and consumers rarely behave rationally in the economic sense. In the short run, firms with the same information may react differently until they *learn* its significance. Temporary knowledge asymmetries create profit opportunities. The 2002 Nobel prize in economics shows that even in the long run, firms and their customers may behave “irrationally”. The prizewinning work established the foundations of Behavioral Economics. It shows that people take shortcuts in evaluating information, and exhibit inconsistent attitudes towards risk. Behavioral Finance is already an influential discipline on Wall Street, but strategy theorists have yet to catch up. Profit opportunities from irrational behavior are ignored by traditional strategies.

Some Information Economy experts spread the confusion. They tell executives to divide the economy into atoms and bits. But just because information and knowledge can both be represented in bits does not mean they are the same thing. Those who confuse information and knowledge miss something vital.

New Profit Opportunities

Efficient markets are the enemy of profits, but there is no efficient market in information and knowledge. Information asymmetries abound in the real world. Irrational behavior is ubiquitous, not only because of human nature but because firms have different knowledge and learn at different rates. These inefficiencies create profit opportunities. But executives cannot seize these profits using traditional strategies. To capture profits from information asymmetries and “irrational” behavior, executives must change the way they think about the firm.

Information, Knowledge and Action – The IKA Model of the Firm

We define a firm as something that creates value by combining information, knowledge and action. We call this the *IKA model* of the firm. In our definition, information is an *input* to the firm and knowledge is *within* the firm. Action represents the power to produce or buy something, like labor or financial assets.

Consider the example of an oil exploration firm. The firm needs information in the form of seismic data and drilling samples, knowledge to analyze and interpret the information, and the ability to act on the findings by buying an oil field. Information, knowledge and action are all necessary to create value.

In the IKA model, executives have only one objective: *maximize the return on investment in information, knowledge and action*. None of these factors is free. *Search costs* are incurred to acquire information, and *learning costs* are expended to create new knowledge. Applying existing knowledge and acting also require investment.

However, the cost of these three factors is interdependent. Investment in knowledge affects the value gleaned from information. Investment in capital equipment can multiply the value of knowledge. Conversely, new knowledge can render physical assets worthless. This interdependence creates opportunities to trade off expenditure on information, knowledge and action to increase return on investment.

For example, an oil exploration firm can choose to invest in more seismic data, more analytical resources, or more oil fields. More seismic data could produce a large return on investment by reducing the risk of buying low-quality reserves. But if time is short, the delay involved in getting more data could risk the whole deal.

Executives face difficult trade-offs when investing in information, knowledge and action. However, combining trade-offs with market inefficiencies creates profit opportunities. Consider Microsoft.

Microsoft and the Deal of the Century

When IBM decided to develop the PC, Microsoft was a small software company selling programming languages such as BASIC. Digital Research was the leader in operating system software, with a product called CP/M. IBM called both companies. Bill Gates responded right away, but Gary Kildall at Digital Research quibbled over contract terms before entering negotiations. Kildall was hesitant to invest resources in a version of CP/M for the IBM machine. IBM was in a hurry, so they asked if Microsoft could develop an operating system. Microsoft didn't have the resources. However, Microsoft's Paul Allen knew of an operating system developed by Tim Patterson at Seattle Computer Products that could be adapted. Microsoft bought Patterson's operating system for \$50,000, without telling him the identity of their client. This is now known in the computer world as the Deal of the Century, and the rest is history. ²

In the efficient market assumed by traditional strategy approaches, this Deal could not have happened. Kildall would have acted "rationally" and aggressively pursued the IBM opportunity. IBM would have eliminated information asymmetries by inviting bids for the operating system development, alerting Patterson to the opportunity. Microsoft could have no knowledge advantage over IBM regarding the value of owning the operating system. IBM would have used its distribution muscle to demand majority ownership of what became MS-DOS. Instead, Microsoft became the world's most successful software company by exploiting information and knowledge asymmetries and irrational behavior.

Business Strategy the IKA Way™

Microsoft's case is often seen as an example of luck and entrepreneurial genius. However, Business Strategy the IKA Way™ allows executives to capture these profit opportunities using a disciplined approach.

Business Strategy the IKA Way™ exploits, creates and protects valuable information, knowledge and action advantages. Our methodology identifies the client's most valuable IKA advantages. Because information, knowledge and action are the fundamental sources of value, analyzing IKA advantages reveals all sources of potential profit. We find new ways to exploit existing advantages, and identify new advantages that can add significant value. We identify opportunities to exploit information and knowledge asymmetries and "irrational" behavior, and innovative ways to "trade off" investment in information, knowledge and action.

Based on this analysis, we design an investment portfolio to maximize return on investment in information, knowledge and action. Often, little new investment is needed. That's because every dollar spent on salaries is an investment in information, knowledge or action. With Business Strategy the IKA Way™, executives reallocate existing resources to exploit profit opportunities.

Business Strategy the IKA Way™ creates additional profits from innovative sales and marketing. It also obliterates the barrier between strategy and implementation.

Innovative Sales and Marketing

The IKA model is unique because it applies to customers as well as firms. Customers make purchasing decisions based on the information available to them, their beliefs or knowledge, and their ability to act. Like firms, customers decide based on imperfect information. They filter information based on their beliefs. Customers can act "irrationally". Acquiring information and knowledge about a product takes an investment of time and effort, and customers differ in how they make that investment.

Because the IKA model applies to both customers and firms, *IKA profit opportunities exist on both sides of a transaction*. Customer IKA costs create profit opportunities that can be captured by innovative sales and marketing. For example, selling “solutions” exploits information and knowledge asymmetries and lowers customers’ search and learning costs. Lou Gerstner used this strategy to effect IBM’s turnaround.

Business Strategy the IKA Way™ incorporates customer behavior into the strategy process. It uses sales and marketing strategically. And by combining the economics of information with customer behavior, the IKA model makes sense of the Internet.

Obliterating the Barrier between Strategy and Implementation

Because working on information, knowledge and action is what executives do, the IKA model *eliminates the barrier between strategy and implementation*. Traditional strategies often neglect learning and fail in implementation. But the IKA model applies to the organization *and* the strategy. Every dollar spent on salaries is an investment in information, knowledge or action. By identifying valuable information, knowledge and action, the IKA model shows executives how to invest their resources to implement strategy. Executives develop a *learning investment portfolio*. Organizational learning and knowledge management become strategic initiatives.

The IKA model also guides organizational design. Parts of an organization should be designed to respond quickly to valuable information. Others should be designed for consistent exploitation of strategic knowledge or efficient action. Non-strategic functions should be outsourced. The IKA model helps to evaluate outsourcing decisions by weighing savings against the value of the IKA advantages that might be lost. In Business Strategy the IKA Way™, organizational design is a competitive weapon.

A New Way

With Business Strategy the IKA Way™ executives seize new profits from information and knowledge. They use a deep understanding of customer behavior to create new value from innovative sales and marketing. Organizations become competitive weapons. The distinction between strategy and implementation disappears. Executives and employees understand how their daily work creates value, and every dollar spent on salaries is a profitable investment.

References

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- ² Ichbiah, Daniel and Knepper, Susan L., “The Making of Microsoft”, Prima Publishing 1991.

Percipient Consulting

Manage the IKA Way™

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