

I How's *your* due diligence?

Managing on outcomes is like steering a car by looking in the rear view mirror.

Attributed to Myron Tribus

I.1 WHERE WERE WE?

Each of the pieces of information in Exhibit 1.1 relates to a real situation for a company or enterprise. Some of them were large, some small, some business and some governmental.

Most were associated with a disaster.

And each disaster could have been prevented by a Board requiring "appropriate" reporting of performance.

EXHIBIT I.1. Welcome to the Board!

Welcome to the first meeting of the new Board of Golden Industries Group Inc.

As the new Chairman, I present to you a provisional first-quarter report for GIGI.

Following the company's recent scandal, several key employees have left and there's not much hard information available. In particular, we can't yet get any reliable financial reports.

However, I have prepared an interim report based on some summary data that the previous CEO had collected:

- a. Share price up nearly three-fold in last six months
- b. Payroll costs reduced by 10 percent
- c. Acquisition of major competitor set for June
- d. Record sales for a December quarter
- e. 95 percent Customer Satisfaction achieved
- f. April release of a new genetically modified crop
- g. Annual staff survey score 3.8 (up from 3.6)
- h. LTI (Lost Time Injury) 9.7 per 10⁶ hours worked (down from 9.9)

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What's the crux of the problem? In essence, in each case there was no *sound quantitative basis for making decisions*. While the various pieces of data looked good in isolation, each was misleading. For example,

- a. The change in share price occurred during Al Dunlap's period as Chairman of Sunbeam.¹ The dramatic rise in Sunbeam's share price related more to major sales being brought forward, rather than to improved sales performance.
- b. The reduction in payroll costs was a consequence of the departure of three key individuals in a knowledge-based enterprise.
- c. AT&T acquired a competitor, NCR, without carrying out a prior Customer Value study to assess its relative market position.² Had they done so, the acquisition may well not have proceeded, at least not on the terms as negotiated.
- d. Part of the Sunbeam story (*cf.* (a)): There were enormous increases in sales of electric blankets in the third quarter (of 1997), usually a fourth quarter phenomenon, and then of barbecues in the fourth quarter, when hardly anyone usually purchases them.
- e. Part of the AT&T story (*cf.* (c)): Customer satisfaction was not being understood or assessed appropriately.³
- f. A failure to measure and manage community concerns with genetically modified (GM) crops led to community rejection of GM food after very considerable investment in research and development (R&D).⁴
- g. Data need to be available in a timely fashion to support appropriate preventative action. You can't wait several months to find out that there is sudden disenchantment in the workforce. Some of your best people may already have voted with their feet: see the case study in Chapter 5.
- h. This wasn't a genuine decline: It was simply a random fluctuation in the measurement due to the limitations of sampling. There

were, in fact, no grounds for reassurance about improvement in the level of safety, a critical issue for that company.

Our concern, in this book, is to describe a system that helps you guard against these sorts of problems that puts metrics in front of the leadership in a form that enables them to exercise due diligence in running the enterprise.

I.2 WHERE ARE WE NOW AND WHERE ARE WE HEADING?

If Exhibit 1.1 represents the performance measurement report from hell, what might you want from a good report? Here is a wish-list:

- a. **The big picture.** Where are we now? What are the trends?
- b. **Timely warning of emerging issues.** What issues are looming, that we can mitigate or avoid completely?
- c. Assurance that all critical areas of the business are being covered.
- d. **Actionable data.** Where do we need to focus attention, and why?
- e. Capability to drill down when needed.

Where are we now? This information is provided in Exhibits 1.2 and 1.3, which should be interpreted as *electronic* reports. Between them, they cover all aspects of the business. Exhibit 1.2 shows the current situation with *some* key Owner metrics, mainly financial and risk indicators. We have chosen to use the context of a national retail group so that meaningful financial indicators can be provided. Features to note include:

- many financial indicators are *ratios*, to facilitate benchmarking;
- all indicators have associated trend charts;
- arrows indicate whether there has been any significant change since the last report; and
- overall Risk is assessed on the scale 0 (no risk) to 100 (maximum risk). The exclamation mark (!) indicates that a serious issue was detected at a lower level so the mark persists to the top-level report.

With this information, an overall picture of the current situation can be grasped very rapidly. For example:

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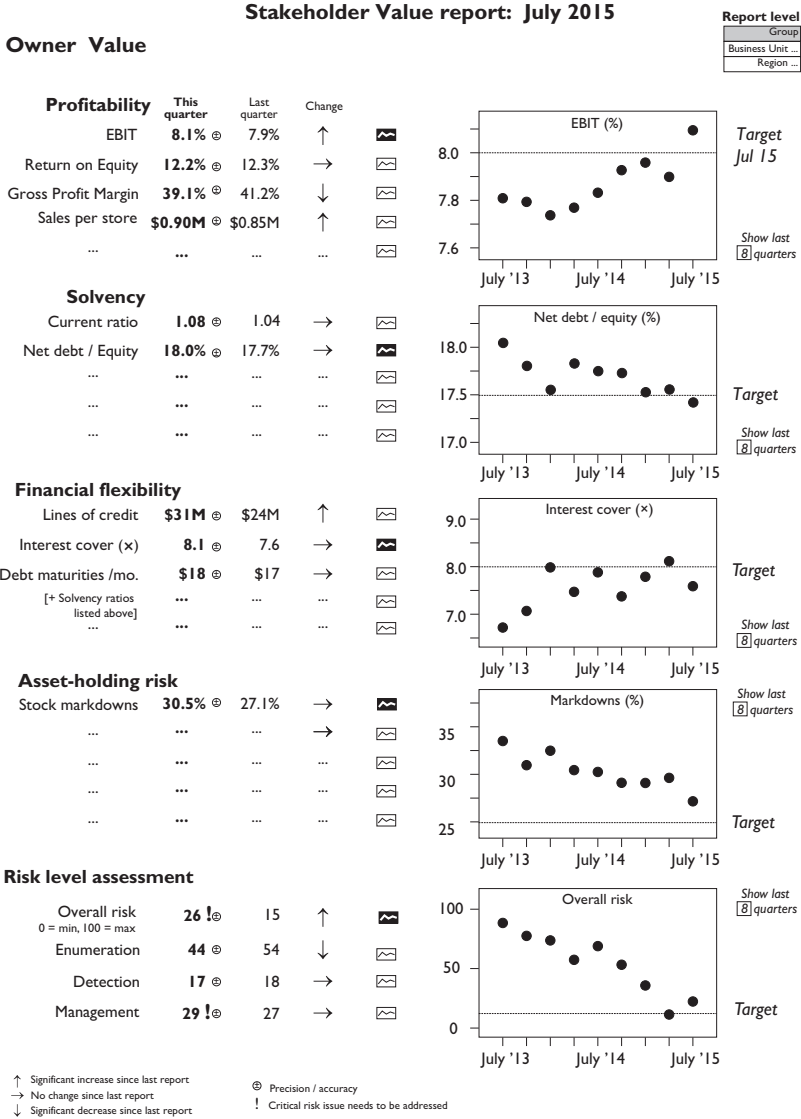


EXHIBIT I.2. This exhibit contains top-level financial metrics and risk indicators for the Owner as stakeholder. Arrows denote significant movement since the previous report, trend charts are available for all measures. The icon ⊕ contains information about precision and accuracy of the corresponding performance metric. The alert (!) denotes a critical risk issue that arose at a lower level, and is forced to persist to the top level of reporting. The chart icon (dark when selected) is used to view a chart.

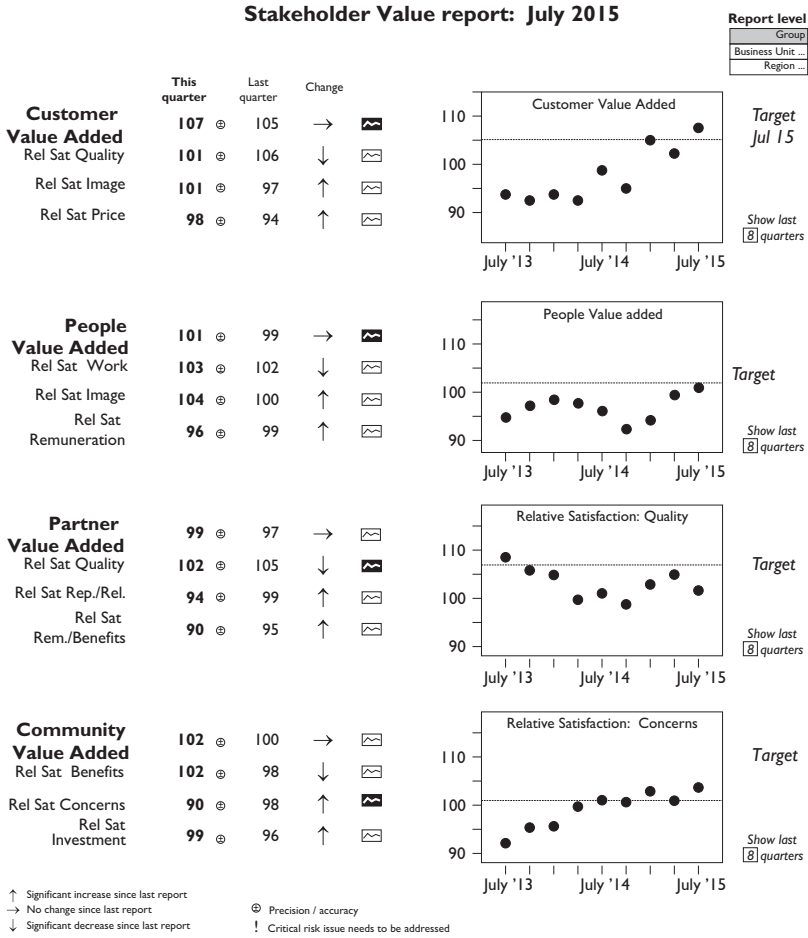


EXHIBIT 1.3. This exhibit complements Exhibit 1.2, by providing the top-level measures for the other stakeholder groups. All scores are relative to 100 (par with the competition). The icon ⊕ contains information about precision and accuracy of the corresponding performance metric. (For such relative value scores, the precision is typically ± 2). Each relative value score has three drivers. Collectively, they capture the current position with all stakeholders (they are lag indicators).

- The financial indicators (Exhibit 1.2) reveal a satisfactory situation. The significant movement in EBIT over the last quarter has brought it up to the target level. The other financial indicators are at or about the targets set for the end of June.

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- There has been steady and sustained improvement in overall management of Risk (last panel in Exhibit 1.2). However, there is an alert (!) of a critical issue and it derives from how a particular risk issue is being managed. The electronic nature of the report facilitates access to a short report (Exhibit 1.4(a)) to provide further explanation. This indicator is reserved for a mission-critical risk. It may have been detected at quite a low level in the enterprise, but is so serious that it must be drawn to the Board's attention, so it cannot be erased from the system except at Board level: the warning must persist in all higher-level reports.
- The enterprise has performed strongly in the marketplace over the last year (first panel of Exhibit 1.3) and is in a dominant position

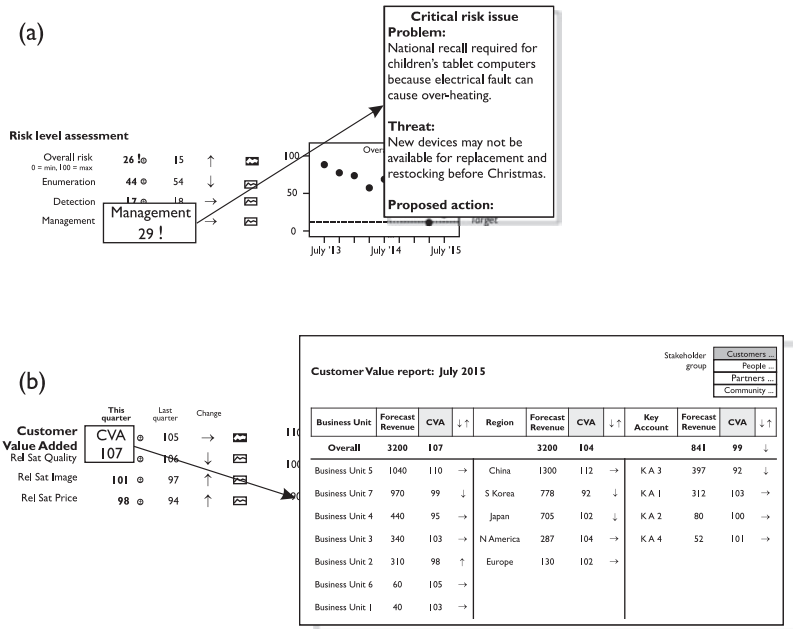


EXHIBIT 1.4. Reports provide the capability to drill down. (a) The Risk Management alert in Exhibit 1.2 has an associated note providing relevant details. (b) The high Customer Value Added score in Exhibit 1.3 can be studied in more detail by looking at an associated report, showing CVA scores by Business Unit, Region or Key Account.

despite an overall drop in perceived Quality, relative to the competition. Exhibit 1.4(b) reveals greater detail about where the excellent performance is occurring.

- An improved performance with People over the last year has the enterprise close to its target, which was slightly above par.
- Relationships with Partners are consistently below the target the enterprise had set for itself, and some sort of specific intervention might be required.
- A committed two-year effort to improving the relationship with the Community appears to have worked well.

These exhibits tell the Board where things are now. To the extent that they are good numbers, they are measuring the success of past efforts by the enterprise to create and add superior Value for all stakeholders.

However, the more interesting question is:

Where is the enterprise heading, and where should it focus its improvement activities?

For this, we need corresponding sets of *lead indicators*.

Exhibits 1.5 and 1.6 show indicative related reports for Owners and for other stakeholders, respectively, to provide a flavor of the sorts of actionable data you need to operate diligently as a leader. As far as financial indicators are concerned, we need to be somewhat specific about the industry sector, as there can be enormous sectoral variation in indicator benchmark values.

Again, the key information in Exhibits 1.5 and 1.6 is readily accessible for leadership. For example,

- From Exhibit 1.5, *Consumer sentiment* is trending up (allowing for a seasonal effect), a good lead indicator for EBIT. The trends in Debtor Days (lead indicator for Net debt/equity), Share price (Lines of Credit) and Unforeseen events classified as “high risk” (Overall Risk) are also in the right direction.

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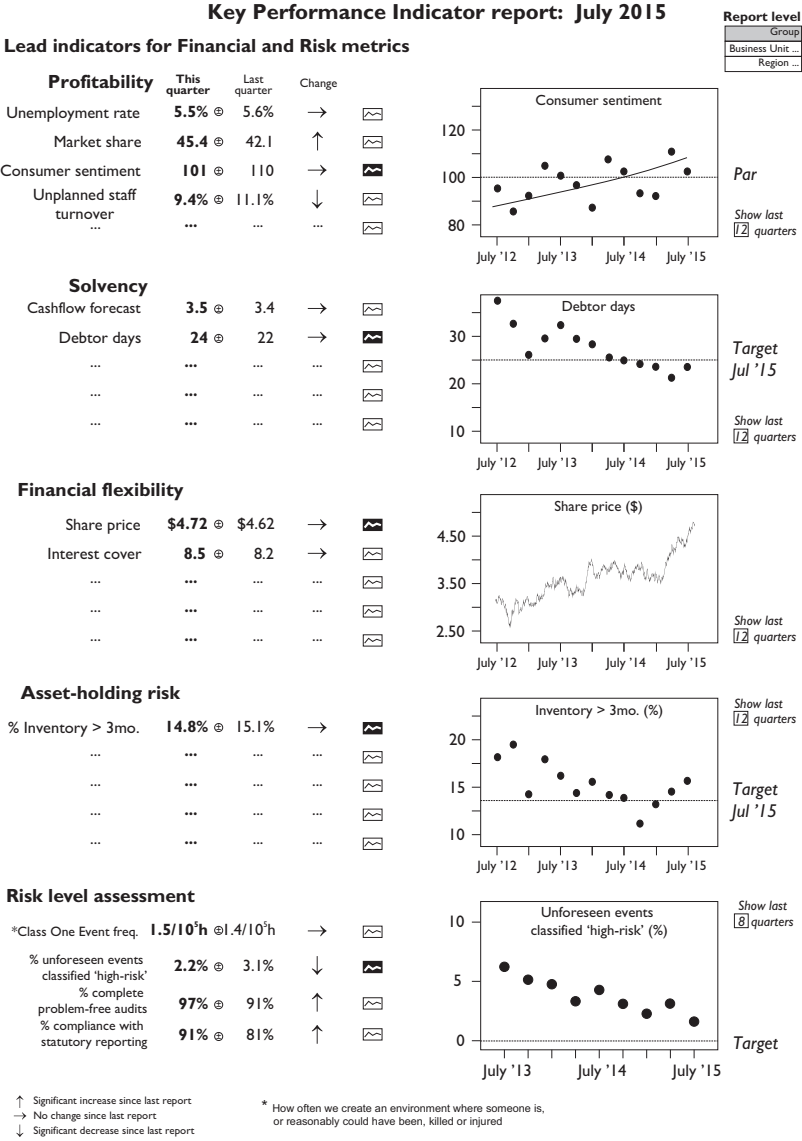


EXHIBIT 1.5. The purpose of the indicators in Exhibits 1.5 and 1.6 is to help predict where the enterprise is heading, to enable the leadership to take action in anticipation of problems, and also to capitalize on emerging opportunities. Note how trends in individual graphs in Exhibit 1.5 anticipate corresponding trends in Exhibit 1.2. The indicators in Exhibit 1.5 relate to the financial and risk management aspects of the business.

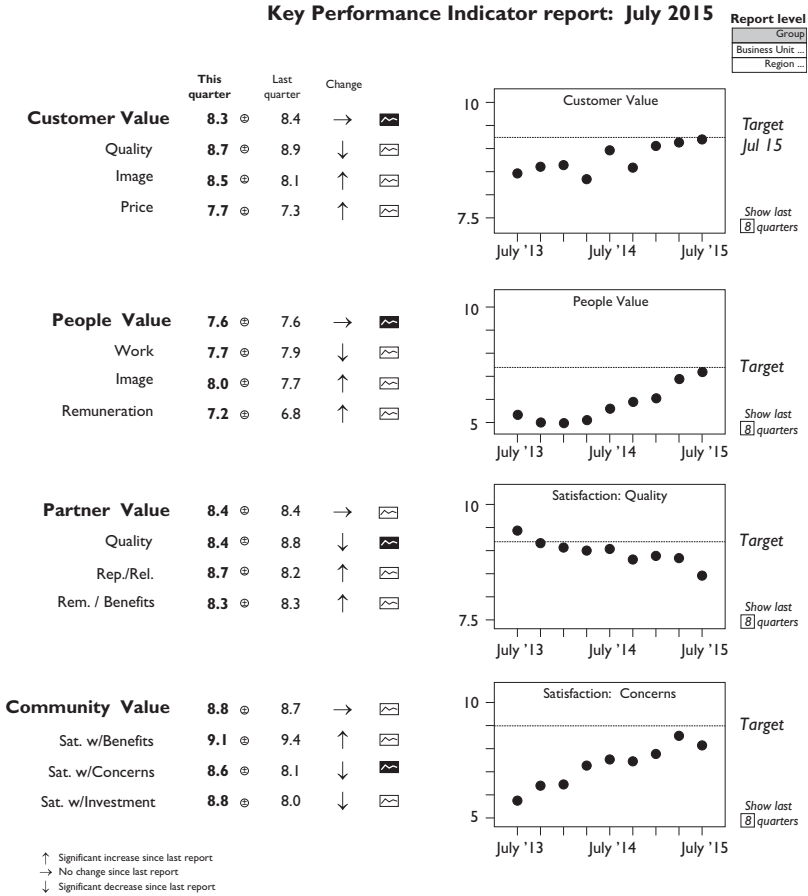


EXHIBIT 1.6. This exhibit complements Exhibit 1.5, by providing lead indicators for the other stakeholder groups. All scores are ratings on the scale 1 (Poor) to 10 (Excellent). They are the current ratings for your enterprise, whereas those in Exhibit 1.4 are measured relative to your competitors.

- For the category *Asset-holding risk*, Age of inventory has started to increase again, which may not augur well for future *Stock markdowns*.
- From Exhibit 1.6, we conclude that the enterprise is steadily improving its position as far as *Customers* and the *Community* are concerned.

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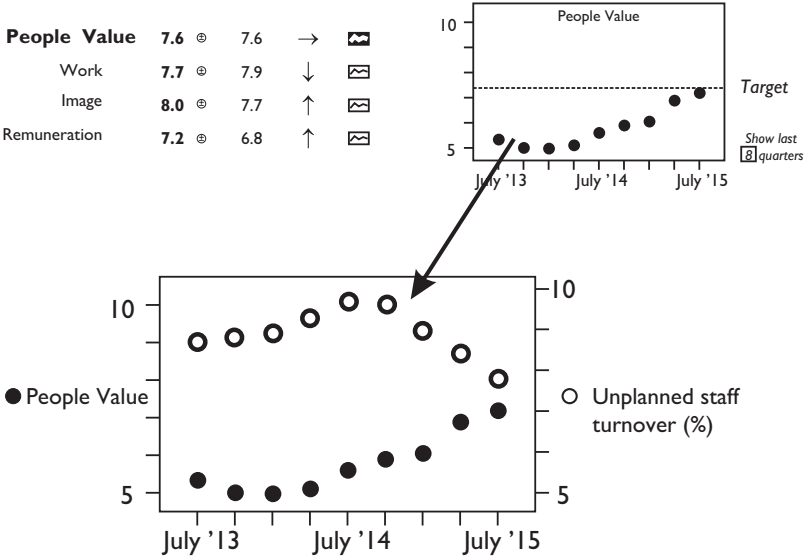


EXHIBIT 1.7. People Value as a lead indicator of Unplanned staff turnover. It is usually helpful to produce lead and lag indicators on the same graph so that the nature of the relationship can be appreciated, which can then be validated by statistical modeling and analysis.

- *People Value* was at a very low point, but now appears to be improving steadily. If *Unplanned staff turnover* data are available, we would expect to see the sort of pattern shown in Exhibit 1.7: as *People Value* increases, after a lag of a few quarters, *Unplanned staff turnover* starts to decrease.
- There is an issue with *Partner Value*, where the overall Quality of the *Partner relationships* has been declining steadily for two years. It hasn't yet reached the point of being flagged as a mission-critical risk, but something clearly needs to be done.

So, how do you decide which numbers *you* actually need? That is what is discussed over the next several chapters. The goal is to develop a set of metrics that provides a concise yet comprehensive view of the current situation and where you are heading; in other words, a set of numbers that will provide assurance to you, your colleagues and your shareholders that you are being duly diligent.