COUNTING WHAT COUNTS

MARC J. EPSTEIN • BILL BIRCHARD

Counting What Counts

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THE ACCOUNTANT'S GUIDE TO LEGAL LIABILITY AND ETHICS
MEASURING CORPORATE ENVIRONMENTAL PERFORMANCE
THE SHAREHOLDER'S USE OF CORPORATE ANNUAL REPORTS
INTRODUCTION TO SOCIAL ACCOUNTING

Counting What Counts

Turning Corporate Accountability to Competitive Advantage

Marc J. Epstein
Bill Birchard

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PREFACE

On many a shelf, in many a home, there sits an old music box. A box filled with memories and probably a few cracked pins. The box may malfunction, but from time to time many of us take it down, wind it up, watch the drum go round and round. We probably nod with approval as a melodious tune floats through the air. We wince as the bad pins plink and buzz.

The state of accountability in corporations today reminds us of such a music box. A lot goes well inside companies, but the internal workings of many organizations have a pattern of weak spots when it comes to accountability. These weaknesses prevent companies from consistently delivering the sweet sounds of value, whether measured in the plink of cash or the hum of satisfied customers.

Many people who work for companies, who buy from them, and who supply investment capital often feel they're dealing with defective music boxes. They are aware of the dead spots in performance, and they periodically want to throw up their hands at annual reporting time and banish the corporate boxes to the attic.

But the glitches in accountability have a fix. We have assembled in this book the makings for that fix.

- We explore the reasons for the lapses in accountability.
- We present a new model that clarifies the concept of accountability (Chapter 7).

- We tell the stories of executives who champion the principles and practices of accountable management.
- We offer an action plan—four best practices—for using accountability as a lever to deliver unparalleled performance.

We offer a richly detailed book that is part research document, part how-to book, and part business manifesto. We blend the most thought-provoking elements of the latest academic research, company cases, and firsthand executive experience to document the state of the art in accountable management. We integrate our findings into a prescription for turning accountability into competitive advantage. We issue a call to action for top executives, general managers, financial executives, and accounting professionals to look for the next edge in business in the venerable concept of accountability.

The ideas we present in this book came to us not in a bold stroke. More than twenty-five years ago, Marc Epstein began researching, writing, and consulting in financial accounting, managerial accounting, and social accounting. He produced thirteen books and nearly one hundred academic and professional papers. His work covered everything from the use by shareholders of corporate annual reports to the use by managers of nonfinancial measurement in decision making to the preparation by accountants of reports on environmental performance. The research seemed to follow a zigzagging course of investigation. On the one hand, it included research into the role of accountants and auditors in society. On the other, it included a twenty-year comparison (since 1975) of how shareholders from all fifty U.S. states use company accounts and make investment decisions. This was a diverse stream of research, but it always flowed from a single source of inspiration: the notion that the financial, operational, and social aspects of business must be tied together as integral aspects of the accountable organization. This book is the concrete outcome of that insight.

Beginning more than ten years ago, Bill Birchard began writing about a broad array of business topics, as editor of *Enterprise* magazine, as contributing editor to *CFO* magazine, and as contributor to *Tomorrow* magazine. In the last five years, he specialized in topics related to performance measurement, governance, environ-

mental management, and accountability. He reported, in his articles on environmental management, a startling development: Seemingly overnight, starting in the early 1990s, managers in company after company were reversing their guarded approach to reporting their successes and failures. They had become answerable for their performance, which was measured quantitatively. They answered to their bosses. They answered to their boards. And they answered to the public. This turned out to be a tip-off: Corporations had begun to use accountability like never before—and not just to improve environmental performance. This book stems from that initial realization.

In our partnership as authors, in which we merged two independently conceived book proposals into a new, stronger one, we bring together the best of two worlds—a book that combines the research, inspiration, and insights of an academic with the reporting, writing, and conclusions of a journalist. Although we bring our book to life with story after story of chief executive officers, chief financial officers, and other senior executives who are leading accountable organizations, readers can rest assured that our message stands on a broad and deep base of academic research and expertise.

In writing the book, we started out looking for companies that we would consider paragons of accountable management. We found none that were perfect in all respects. We found that many were doing a terrific job in one way or another, improving their operations through at least one piece of accountable management. By telling the stories of these many companies, we provide in one volume a composite view of the accountable firm of the future.

Executives in many corporations—in finance, operations, research and development, marketing, and human resources—have begun to use accountability to tremendous advantage. We show that by adopting a new model of corporate accountability—comprising improved internal and external performance measures, reporting, management systems, and corporate governance—they are delivering untold benefits. They have given the dead spots in the corporate music box a bright new sound of life.

Of course, our book draws on conversations with many unnamed executives, consultants, and university faculty and students, many

of whose own work appears in the bibliography. To them, we are deeply indebted. Special thanks go to valued and trusted colleagues, mainly at Harvard, Stanford, and INSEAD (European Institute of Business Administration), including Robert Kaplan, Krishna Palepu, Robert Simons, William Bruns, Jr., Srikant Datar, Kirk Hanson, Jean-François Manzoni, and Moses Pava for their guidance and friendship over the years. Special thanks also go to Carolyn Brancato, Robert Monks, Baruch Lev, Steve Hronec, David Norton, Bennett Stewart, Dan Keegan, Robert Howell, Alan Brache, Shelley Taylor, Thomas Stewart, and others who have devoted their careers to issues of corporate accountability.

We also thank the executives who took time to tell us their experiences for this book, and who took the time once again, just before publication, to review passages in the book for accuracy and currency. In particular, we thank Jerry Choate, Tom Wilson, and Loren Hall at Allstate; Dana Mead, Bob Blakely, Barry Schuman, and Richard Wambold at Tenneco; Bill McGuire at United HealthCare; Gerry Isom and Tom Valerio at CIGNA Property & Casualty; Dennis Kozlowski and Philip Hampton at Tyco International; Earnie Deavenport, Virgil Stephens, and Jimmy Tackett at Eastman Chemical; John Roth, Megan Barry, and Mark Brownlie at Nortel Networks; John Shiely at Briggs & Stratton; Bob Hoffman, Steve Stetz, and Tom Hartley at Monsanto; Leif Edvinsson, Gordon Boronow, and Jan Hoffmeister at Skandia Group; Ralph Hake at Whirlpool; Bob Wells at Bank of Montreal; Fran Corby at Harnischfeger; Terry McClain at Valmont Industries; Gordon Petrash at PricewaterhouseCoopers (formerly with Dow Chemical); Ron Loeppke, Marlene Giesecke, and Jerry Howell at PhyCor; Bill Blackburn at Baxter International; Don Mullane at Bank of America; Mark Green at Pitney Bowes; Geoffrey Bush at Diageo; Mark Lee at Business for Social Responsibility (formerly with VanCity Savings); Robert Stasey at Analog Devices; Fred Larcombe at Cambrex Corporation; Bob Banks at Sun Company; Don Macleod at National Semiconductor; Phil Hillman at Polaroid; Tom Hellman at Bristol-Myers Squibb; Ed Lewis at Mobil; Chris Tuppen at British Telecommunications; and scores of other people in companies that helped in big and small ways to supply the information for this book.

We especially thank four anonymous reviewers who read the entire manuscript and gave many helpful comments.

We also thank our agent, Helen Rees, and our editor, Nick Philipson, for their support and encouragement.

Finally, we thank our wives, Joanne Epstein and Sue Birchard, and our children and their families, Simcha, Debbie, Emily, Scott, Judy, Amanda, Jake, and Kye. We owe them all at least one well-run music box to make up for their indulgence in putting up with the demands of the research and writing life.

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PART ONE

The Promise of Accountability

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1

The Accountability Advantage

In the spring of 1989, Ed Woolard, then chairman of DuPont, gave two speeches that would help him make his mark as a maverick. The then-freshly minted DuPont chief executive declared that, among other goals, DuPont would cut toxic air emissions by 60 percent, carcinogens by 90 percent, and hazardous waste by 35 percent.

Woolard stood at the podium and made gargantuan commitments without knowing exactly how the company, the biggest U.S. polluter, could comply. "My people told me I couldn't do that!" he later recalled. "I said, 'Well, I've done it, done it publicly. Now you guys have to do it—it's your job!'"[1]

At the time of the incident, many people inside DuPont would maintain that Ed Woolard had lost his management sense. With the benefit of hindsight, however, they would unanimously say the reverse: He had brought new sense to management.

Woolard was choosing public accountability—naming targets and promising to report on progress publicly—in a stunning drive to boost company performance. It worked wonders. By the time he retired as chairman eight years later, in 1997, DuPont had cut toxic air emissions by 60 percent, carcinogens by 75 percent, and

hazardous waste by 46 percent—all documented quantitatively in an annual environmental report.[2]

In the annals of management, the most remarkable move by Woolard was not that he set a new course on the environment—although that was noteworthy—but *how* he set it. "The first thing we did," he explains, was to declare that "we're going to measure everything, and we're going to make public commitments."[3]

Woolard followed up, too. He called upon DuPont's thirty-three highest-level managers to sign "The DuPont Commitment." The document obliged every executive to drive his or her operations toward zero waste generation, zero emissions, and zero accidents. The single page ended with the pledge: "We will measure and regularly report to the public our global progress in meeting this commitment."[4]

Few managers fully understand the notion of accountability. They can't define the concept clearly. Nor can they readily apply it to gain day-to-day or long-term advantage. However, developing full accountability can give an organization a powerful competitive edge in implementing strategy and in helping individuals, teams, and business units deliver unparalleled performance.

Unfortunately, most people interpret accountability as a code word for organizational policing. The concept evokes the image of a higher authority, stern-faced, banging the table for an explanation—while the culpable party, lips pursed, gets squeezed uncomfortably to come clean. When people embrace the notion of accountability, they often do so for the wrong reason—for the satisfaction of making the *other* guy accountable.

However, this menacing, autocratic form of accountability contrasts with an appealing, empowering variety. Rather than act as a stick to keep people in line, the principles of accountability can act as a carrot to keep them climbing to higher levels of performance. The greatest beneficiary of accountability need not be some higher authority, an outsider, or a special-interest group. It can be the organization itself, propelled by goals set by leaders like DuPont's Woolard.

It is time to revise the meaning and use of the concept of accountability. To realize its potential, managers must turn its reputation around. They must throw out the bad cop and bring in the good one. They must use accountability as would an inspiring, if demanding, teacher, to rally people to fulfill lofty ambitions.

Because the word accountability appears in many contexts—business, law, morality, government, politics—few people agree on its meaning. However, the true test of an accountable organization is specific: whether it measures performance quantitatively—with financial and nonfinancial numbers—and reports it publicly to audiences inside and outside the organization. Anything less than hard numbers, broadly disclosed, reveals an organization hesitant to commit to full accountability. The act of one party answering to another in qualitative terms alone is not enough. Accountability requires data. As Charles Handy says, "Counting makes it visible, and counting makes it count."[5]

Indeed, the late Coca-Cola Chief Executive Roberto Goizueta repeatedly declared shareholder value his objective, so he measured and reported the closest quantitative proxy he knew for showing his company was accountable for building that value—economic profit.

Tenneco Chief Executive Dana Mead has repeatedly declared cost and quality his objective, so he has measured and annually reports the single most pertinent figure that shows the company is succeeding: reductions in failure costs (the sum of scrap, rework, warranty, litigation, and other costs).

Skandia Chief Executive Lars-Eric Petersson declares developing customer relationships a prime objective, so Skandia's multiple insurance units report satisfied customer indexes, insurance-policy surrender ratios, and other hard-edged numbers.

Former Allstate Chief Executive Jerry Choate declared equal employment opportunity a prime objective, so Allstate publishes race and gender data, by job category, as reported to the Equal Employment Opportunity Commission.

Executives like these recognize that traditional practices for measuring, managing, and accounting for performance are no longer enough. They find accounting according to generally accepted accounting principles (GAAP) awkward and outmoded, hardly up to helping managers compete effectively in global capital, labor, and product markets. They recognize what leading thinkers like Michael Porter have maintained for years. Individual companies cannot operate at peak performance, nor can the economy as a whole effectively allocate capital, without an overhaul of accounting.

In a landmark report in late 1995, Porter and Robert Denham urged the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board "to undertake a project to develop generally accepted principles for measuring salient categories of nonfinancial information." They cited such categories as customer satisfaction, process quality, and work-force training.[6] To achieve record-breaking performance, companies must retool their management and accounting systems.

What managers will find is that new forms of measurement have tremendous power to enlighten and empower decision making internally. That's where the magic of accountability starts. These measurements also give the accountable company an entirely new advantage: the ability to enlighten decision making with the insights of outside stakeholders. That's where the concept of accountability explodes with new possibilities—in enabling the company to win advantage by inspiring loyalty in all stakeholders vital to corporate interests. This one-two punch—first, measuring, managing, and reporting performance internally; and, second, presenting the numbers externally—promises corporations a new competitive advantage.

This book explores how companies can gain this advantage. First, it offers an inside look into how leading managers have embraced the practices of accountable management. Second, it shows how companies have used accountable management as a springboard to better performance. Drawing on the best practices of these companies, we portray a composite view of the accountable organization—along with a model of that organization, an approach to building it, and the tools for realizing its potential.

THE ACCOUNTABLE PERFORMANCE

The job of building the accountable organization, in spite of the focus on data, is not first or foremost a task of accounting—even if accounting numbers are the *lingua franca* of accountability. It is a task of management. In the same way that a critically acclaimed theatrical production calls for a well-wrought script, a cast of skillful characters, and plenty of direction and support backstage, the accountable organization calls for a set of rigorous practices; strong

leadership; and robust management, accounting, and information systems to support them. The final show—the accounting of performance—represents untold discipline behind the scenes, starting with the dedication of general managers, financial executives, and top operations managers to adopting the full complement of practices that typify the accountable organization.

Most companies today have only begun to fit together all the pieces of a critically acclaimed show of accountability. However, across industry, companies have created a remarkable buzz of activity. In the first half of this book, we chronicle that buzz. To be sure, we find that no single company today operates with every element of accountability. Still, many companies are crafting masterful one-act dramas that fit into the larger accountability play. In the second half of the book, we show how all companies can bring together the pieces—the best practices—in a single model to create a production of an accountability masterpiece.

Our research, based on hundreds of interviews with company managers, our own extensive studies and surveys over twenty-five years, and a review of the vast academic and managerial literature, shows that, as managers create the buzz of activity, they plunge deeply into four different approaches to accountability: governance, measurement, management systems, and performance reporting. Managers create active, independent governance; balanced financial and nonfinancial systems of measurement; integrated, closed-loop planning, budgeting, and feedback systems; and thorough, regular public reporting procedures. A combination of these four approaches defines what we call the accountable organization. (See Figure 1-1.)

This combination of efforts is daunting, but our research shows that managers, collectively, have begun to define accountability in just this way. They are looking at the notion much more broadly than in the past. They have jumped beyond accountability as a splinter issue, like paying for performance. They have fashioned inventive solutions to using accountability as a tool for delivering on the promise of the wealth and well-being that can flow from the free-enterprise system. This creates a rich story of accountability never before told. We bring it to life by weaving together the four elements of accountability.

Figure 1-1
The Elements of Accountability

Governance

Who could have missed the most prominent effort today by top managers to address a vacuum of accountability: revamping governance by the board of directors? Managers now roundly concede that traditional governance mechanisms have fallen short of their target of institutionalizing firm, independent oversight that holds management's feet to the performance fire. Recent innovations to improve board governance, although not fully assuaging investors' concerns, are perhaps the most polished act today in the new play for full accountability.

General Motors (GM), for example, rewrote the role of the board of directors after its stumbling performance in the early 1990s. The company so thoroughly recast its governance principles that a commission led by governance expert Ira Millstein cited GM as a model.[7] Among other things, GM requires that the board contain a majority of independent directors, that directors themselves nominate new directors, that a committee annually assess the per-

formance of the board, and that outside directors select a lead director to chair regularly scheduled meetings of outside directors.[8]

Measurement

Managers have struggled for decades with financial and managerial accounting that fails to measure all the variables that drive long-term value. Without taking into account quality, turnaround time, customer satisfaction, and other leading indicators of company wealth creation, managers at all levels have simply made bad decisions. Leading managers have attacked the issue of accountability by inventing many new ways to measure financial, operational, and social performance.

What Peter Drucker said in his classic editorial in 1993 is as true today as ever: "Financial accounting, balance sheets, profit-and-loss statements, allocating of costs, etc., are an x-ray of the enterprise's skeleton. But much as the diseases we most commonly die from—heart disease, cancer, Parkinson's—do not show up in a skeletal x-ray, a loss of market standing or a failure to innovate do not register in the accountant's figures until the damage is done."[9]

Companies are rapidly devising ways to go beyond the x-ray and create much more insightful leading indicators for making decisions and creating value. Arthur Andersen developed a number of key measures for gauging its performance worldwide. Along with financial indicators, the firm measures such factors as customer satisfaction, flexibility, resilience, market share, and employee satisfaction.[10]

Managers have realized that, paradoxically, the best way to stimulate peak financial performance is often not to spotlight the financials at all. A menu of nonfinancials, to complement the financials, can make just about everyone better able to contribute to the ultimate financial health of the company. Clamping managers in the irons of financial targets may actually dull peak performance.[11]

New balanced measurement systems like the ones at Arthur Andersen and Sweden's largest bank, Swedbank, show the future. Swedbank's branches deliver a report card of performance that shows measures of "customer value added" (for example, depth of relationships, loyalty), "people value added" (perception of leadership, perception of competence), and "economic value added" (profit before credit losses, bad debt ratio).[12]

Management Systems

Try as they might, managers have always had trouble linking the systems for corporate strategic planning, business-unit planning, annual budgeting, performance review, and compensation. The systems often have worked at odds with each other. Managers today are trying to make them work as one. The objective is to make the measures defining strategy at the top lead to actual implementation of that strategy at the bottom.

Robert Kaplan and David Norton, in a 1996 study with *CFO* magazine, found 57 percent of respondents reporting only "little" or "some" linkage between the priorities of the long-range strategy and the annual budget. More than two-thirds (69 percent) said that strategic planning had only "some," "little," or "no" influence on the company's overall success.[13]

Senior managers are starting to forge links between isolated pieces of their management systems. They are breaking down top-level measures into subordinate measures for division and team performance. They are asking managers to determine the indicators of success—the *drivers* of long-term value. The measures, then devised by the people accountable for them, gain buy-in. People take ownership for them and the measures keep people focused on the strategies, objectives, tactics, and targets for which they are accountable.

As Kaplan says of frontline workers, armed with measures they understand: "You transform them into people who really deliver the strategy day to day."[14]

Top managers are finding that measures also offer a way to evaluate the strategy itself. Are customers satisfied, say, with the new-product strategy? A proxy for that level of satisfaction is whether they are clogging phone lines with help calls. Are shareholders satisfied with their financial returns? A simple measure is the percentage by which stock-price gains exceed those of the firm's peer group. Are employees going to remain satisfied? One measure is whether, according to surveys, the brain trust of key people in research and development say they are happy—and not inclined to walk. A mix of new and traditional measures gives hard, cold, diagnostic data for evidence. Managers no longer need rely only on end-of-quarter financial numbers, which yield a flow of insight that runs only ankle deep.

Reporting

Finally, managers have begun to push the envelope where chief financial officers often cringe, in reporting data more broadly, both within the company and outside. In an age when most workers inside the company depend on information to innovate, many managers have come to believe the company holds information too tightly for rapid decision making. Hence comes the popularity of "open-book management," in which managers share detailed cost figures with every employee.[15]

However, managers are not stopping with broader reporting inside the company. At a time when company outsiders have more choices than ever to invest their capital, serve an employer, conduct a partnership, and buy products and services, many managers are offering more information to sway decisions in the firm's favor. Managers are concluding that they have no compelling reason to operate with so much performance data hidden backstage. Executives in every function are taking a fresh look at what information they need to run the company. They are providing insights to accountants to help them provide that information, and are drafting plans to disseminate a distillation of that information to people inside and outside the company.

In short, executives have begun to develop corporate communications strategies based on increased transparency. Along with a narrative that tells the story of their corporate strategy, executives are giving more hard data, and hard-hitting descriptive information, to woo shareholders, (prospective) employees, business partners, and customers. What is the payoff? Engaging the collective efforts of all stakeholders—who have a new window on corporate performance—in a never-ending effort to generate ideas and spark innovations to better the business.

The notion of broadly reporting performance numbers publicly is not new. Philosopher Jeremy Bentham, John Stewart Mill's teacher, recognized 200 years ago the power of public accountability. He wrote about the "open-management principle," "all-above-board principle," and "transparent-management principle." Publicity, Bentham maintained, commits companies to their duties. "The more strictly we are watched, the better we behave," he wrote.[16]

Bentham, the founder of Utilitarianism, foresaw as far back as the eighteenth century the power that managers like Ed Woolard exercise today: using a public commitment and accounting spurs unparalleled betterment *inside* the company. The combination of indisputable quantitative figures, along with public disclosure, keeps people focused on their goals.

Of course, managers aren't going public with secrets that hurt competitiveness, but a growing number are realizing that the line separating confidential and public information has shifted sharply. Although on-time shipping performance may have fallen squarely within the domain of proprietary data a decade ago, today it may fall into the domain of numbers that, reported publicly, give the company an advantage.

In any case, the flow of information within society and among business has exploded to such a degree that it calls into question any strategy based on knee-jerk confidentiality. In years past, companies (and managers) could reliably gain an advantage by withholding information or selectively releasing it. They could err on the side of stamping every memo "company confidential." That advantage has turned into a disadvantage, however, as managers on top of the pyramid can no longer easily control the information, like product quality, that reaches the marketplace.

Those managers striving to apply accountability as a tool for high performance are working on all four fronts—governance, measurement, management systems, and reporting—as described in Chapters 3, 4, 5, and 6. However, the company that puts all four of these elements together into a single, broader concept of accountability, as described in Chapters 7, 8, 9, and 10, will stage an unbeatable accountable performance. Top managers at some companies are starting to put this model together. They are winning an audience of investors, customers, employees, business partners, suppliers, and even the public. They are positioning themselves to use accountability's power to spark glittering performances by individuals, teams, business units, and their entire companies.

THE JOYS OF PERFORMING

The power of accountability remains underappreciated. Many managers haven't thought much about it. Most, faced with the idea of hanging out their report card, good or bad, recoil at the thought.

The concept of full accountability is a bit much, if not altogether foreign.

This attitude prevails above all, despite the fact that the accountability as we describe it is a synthesis of practices that managers around the world have already embraced. Nearly all managers have woven at least a few strands of accountability into their managerial fabrics. After all, they comply with SEC regulations to file financial statements and other information. They compile and share defect data for the sake of total quality management efforts. They survey and report customer and employee satisfaction indexes. They rely heavily on these and much other data to make decisions, review performance, and pay bonuses.

Still, many firms are likely to kick and scream on their way to the high altar of accountability that we describe. They will view accountability only as a means for third parties to obtain information from them. They will act as if the idea were invented by overzealous regulators, rather than by innovative managers. They will see a regulatory bad cop with a truncheon for punishing the errant, rather than a management good cop with white gloves pointing the way to the land of high performance. They will belittle calls for more publicly disclosed measurement information as a heap of useless red tape and as unwarranted prying by outsiders.

Admittedly, their point of view responds to a long tradition of lawmaking. When Congress passed the Securities Act of 1933, it prescribed mandatory disclosure to clean up rampant abuse of investors by managers and financial manipulators. That legislation started a process that has seemed to gain momentum ever since. Congress has repeatedly mandated public reporting as a curative, passing disclosure laws on everything from occupational safety and environmental management to equal employment and community reinvestment. In 1997, Representative Paul Gillmor (R-Ohio) even sponsored a bill to mandate disclosure of charitable giving, saying shareholders have "a right to know."[17]

Indeed, the use of public disclosure to force companies to paint a vivid picture of their performance has a long history. In an oft-quoted comment, Justice Louis D. Brandeis observed in 1914: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman . . . [the] potent force [of

publicity] must . . . be utilized in many ways as a continuous remedial measure."[18]

However, the measure of an astutely run business is not participation in a remedial accountability program. Seventy years after the 1929 stock market crash, managers can reap huge rewards by snatching the lead from regulators and peer companies. Even if they stop short of practicing full accountability—even if they just engineer new measures and internal reporting—accountable managers stand to markedly strengthen their companies.

The rewards from building the accountable organization are a lot like those from building the quality organization—the more committed the managers and workers, and the more integrated the concept with company line operations, the more benefit. As a first step, managers must build the accountable systems and practices within the company. They then can build bridges to the outside. As they move toward full accountability—well governed, measured, managed, and publicly responsive—they will position themselves to reap many benefits.

- **Improving decision making.** The accountable organization generates a wealth of information on performance, which informs decision making with facts, not intuition. People both inside the company and outside can make more effective decisions to further company strategy and goals.
- **Accelerating learning.** The accountable organization installs the feedback systems that yield a rapid-fire means of learning from people both across the company and outside the company. The company with the most feedback loops—internal and external—wins.
- **Executing strategy.** The accountable organization communicates each strategy and tactic with specific measures that align direction in a way written objectives cannot. The hard measures then give managers a month-to-month reading on whether the strategy is working.
- **Empowering the troops.** The accountable organization thins the ranks of middle managers that distill and convey information, and it apportions new decision-making authority to the frontlines. As management articulates *what*

it wants with the unvarnished concreteness of quantitative measures, workers have unmistakable guidance as they figure out *how* to deliver it.

- **Communicating the story.** The accountable organization delivers its story of value with credible financial and nonfinancial numbers. As senior managers report more numbers externally, exposing performance transparently, shareholders and analysts will have less reason to undervalue their stock.
- **Inspiring loyalty.** The accountable organization markets its value based on reliable performance measures. The no-smoke-and-mirrors approach spurs cooperation and inspires the loyalty of investors, customers, suppliers, employees, business partners, and even communities.

Reaping these benefits requires plenty of stamina and courage—stamina to implement systems internally, courage to submit to the rigor of a fuller public accounting. In a world where every company is looking for ways to elbow aside competitors, however, managers may have no choice but to exercise that courage and summon that stamina. If not, competitors will. When Coca-Cola snaps up capital by selling its superior accountability to shareholders, millions of investment dollars become unavailable for everyone else—in its industry or in any other.

Top managers will understandably worry about potential liability from all the measurement and reporting that characterizes the accountable company. They may suffer from litigation. They may fear losing proprietary secrets. Many believe reporting costs will skyrocket. Even if these risks were real, and we argue they are specious, they would pale compared to the alternative of not acting.

If a company fails to stage an accountable performance, it cedes the advantage to others. Its competitors can run with more precise information, with leaner workforces, and with better-informed workers. Its competitors can reap more lessons from accelerated learning and from empowered decision making at each level. Its competitors can execute strategy with more diverse feedback. Its competitors can deliver their messages of progress with greater credibility to a more trusting shareholder, employee, or customer. Its competitors can gain an edge by inspiring increased loyalty in

people who supply capital, labor, and purchase orders. Over time, competitors can commandeer the basis on which the company must compete in the future.

Managers can instead seek to gain first-mover advantage—first before politicians, first before regulators, first before competitors. By moving first, they can free themselves from the treadmill of remedial accountability. They can run at the head of the pack—with financial performance like that of Coca-Cola, environmental performance like that of DuPont, quality performance like that of Tenneco, and diversity performance like that of Allstate.

ALL THE WORLD IS A STAGE

As managers embark on building the accountable organization, they can easily become embroiled in an age-old argument: To whom is the firm accountable? The battle lines are typically drawn between two parties, those who answer shareholders and those who answer one or several other stakeholders, typically customers, employees, and community. The argument can stir strident philosophical debate.

As the interests of society and business increasingly overlap, the stakeholder question stirs far fewer debates in practice. Neither the company nor its multiple stakeholders can ignore the benefits offered by the other, and neither can bite the hand that delivers benefits. On the contrary, company managers must work cooperatively with investors, customers, employees, suppliers, and communities to create value together.

Tom Copeland, formerly a partner at McKinsey & Company and now with Monitor Company, has long argued that managers are accountable first to shareholders for creating shareholder value (measured by discounting cash flows). Still, he maintains that in practice, managers have to take the interest of other stakeholders into account, since shareholders are residual claimants on corporate cash flow. Indeed, empirical research supports the notion that increasing shareholder value does not conflict with creating value for all stakeholders. "A winning firm wins in all directions." Copeland says.[19]

Research by John Kotter and James Heskett relating the value that top management places on various stakeholders to long-term

performance, yields similar conclusions. Winning companies, like Hewlett-Packard, don't necessarily balance stakeholder demands. Nor do they necessarily give priority to one or the other. Instead, they put all of them on a pedestal. "You're accountable to more than one constituency," Kotter says. "Once you accept this, the job gets tougher, not easier. If you can't handle that tougher job, you can't handle the tougher economic environment we're facing right now."[20]

Without the governance, measurement, management systems, and internal and external reporting that is at the heart of the accountable organization, managers simply won't make optimal decisions. They will suboptimize, and their short-sighted decisions will come back to bite them.

If business enjoys the best of what society produces—trained software engineers, uncongested roadways for quick deliveries, attractive tax abatements—the members of society expect benefits in return. Even shareholders seem to think such an approach makes sense. In a national survey in which we asked shareholders to rank their preferences of where to allocate more corporate funds, most ranked pollution control and product safety higher than increased dividends.[21]

So the accountable company measures the winnings and impacts on both sides, makes decisions based on the data, demonstrates the value provided through candid reporting, and parcels out the spoils to keep the relationships healthy. The company that operates to give its stakeholders a fair exchange of value will win favor for the future. It can also expect enduring, trusting relationships that lower transaction costs for years to come.

You might expect executives who ardently declare fealty to shareholder value to think differently. Not so. Francis Corby is CFO at Harnischfeger Industries, the $3 billion manufacturer of paper-making and mining machinery, which in 1993 declared economic value added as its primary measure of performance. "I just don't think being responsible to stakeholders is in conflict with shareholder value," he says. Stakeholders "can prosper just as well as your shareholders can."[22]

To be sure, not every stakeholder wins an equal share in every corporate decision. Managers are often faced with tradeoffs that pit the interests of shareholders against those of society or those of customers against those of employees. This book provides guidance on

making such tough choices. Our research, revealed throughout this book, has uncovered a lot more examples of win-win decisions than many managers might believe. Often, such decisions simply revolve around an analysis of short- versus long-term corporate interests. In many cases, viewed in the long term, the same course of action pays off handsomely for both the company and its stakeholders. A company *can* increase the bottom line while also benefiting employees, customers, and society.[23]

Of course, many in business today believe that stakeholders, and often society as a whole, place more demands on the corporation than they are due. They also believe that stakeholders' demands, like support for education, extend beyond what the company is able to fulfill. Whatever the answer philosophically, experience since the late 1980s has shown that many institutions of society—religious, political, social, and educational—are floundering while the corporation thrives. In attempting to cure society's ills, people from all walks of life are looking to the corporation to serve as more than a machine to generate shareholder value—if only because corporations have the money to do so. Witness how the failure of many schools to graduate literate teenagers creates pressure on companies to provide basic education.

As executives try to unravel what makes sense for their businesses, they have to deal as much with perception as with reality. More than half of Americans think a corporation's top obligation is to its employees.[24] It may well not matter, with activist unions, employee groups, and a sympathetic media, if managers disagree. They have to meet societal expectations.

Many people believe the public gives business a "license to operate," that business operates at the pleasure of the public. For good reason or not, small groups of stakeholders can threaten to pull that license. They can pull it, if not in the court of law, in the court of public opinion. So managers will find it in their interest to remain sensitive to outside demands. A prime way of remaining sensitive is to determine if outsiders are happy, to measure the impacts the company has on various stakeholders, to factor a knowledge of those impacts into daily decision making, and to demonstrate with numbers how the company is paying its due.

In many instances, companies will recognize that decision-making power is shifting away from corporate managers to communities, reg-

ulators, and the public. If companies do not proactively give an accounting to society, these constituencies, to remain loyal, will demand it. Often, through the political or regulatory process, these demands will lead inexorably to more reporting. So in the same way that a company can adopt full accountability to remain competitive, it may find that taking action to gauge and report its social performance will help ensure its continued free operation as a valued institution in society.

In the end, the difference between working in the shareholders' interest and working in the stakeholders' interest is small. Of course, sometimes it doesn't look that way, as when a bloated firm runs into trouble and turnaround managers have to cut and wrestle their way back to levels of profitability that pay shareholders a fair return. Moreover, in the short term, it sometimes isn't that way, as executives push win-lose transactions for short-term gain that cost stakeholders far more than they benefit. In the long run, however, what's good for business is often good for society. Managers must take a broad look at performance, measure its many aspects, and report fully on their effect on all constituencies.

As the late Roberto Goizueta, long-time chairman of Coca-Cola, said, "We cannot for the long term exist as a healthy company in a sick society."[25]

THE MISSING ACTORS

Into the hands of top executives falls the main responsibility for making the organization accountable. They must set a new cultural tone, stressing fair appraisals, open disclosure, and continuous learning. They must mandate measurement systems that shift people from a pure financial focus to a balanced focus on building financial, operational, and social value. They must dedicate the people and money to build the information systems that support quantitative measurement and fast, reliable, consistent reporting worldwide. They must courageously set targets and report on progress publicly to show how they have performed for shareholders and other stakeholders.

Although senior managers will provide critical leadership, their efforts will remain insufficient to transform the organization completely. The directors of the corporate board must oversee and

legitimize the managers' work. An active, independent board will ensure trust and rigor in the systems of accountability. Meanwhile, managers throughout the organization, taking their cue from their bosses, must similarly imbue their units with a philosophy of accountability, adopt quantitative measures of performance, and embrace forthright target-setting and transparent internal reporting.

Accountants play a special role in fulfilling the potential of the accountable organization. They have to complete the revolution started in the late 1980s by Thomas Johnson and Robert Kaplan in their landmark book, *Relevance Lost*.[26] Johnson and Kaplan showed that companies had developed management accounting over the course of decades to mainly serve financial reporting. Management accounting had evolved to yield good data on, say, average costs of inventory, but precious little on, say, the real cost to make one product versus another. It provided much data on lagging indicators based on historical costs according to GAAP, but it reported little data on such leading indicators of performance as time to market. The result was that management accounting failed to give managers the information they needed to make daily decisions on how to adjust strategy or run their operations. While pointing out these flaws, Johnson and Kaplan called for delinking the management and financial reporting systems; otherwise, managers would simply make lousy decisions.

Subsequently, Kaplan, Robin Cooper, and others spread the gospel of developing financial numbers for management accounts based on activity-based costing, and of supplementing financial data with a variety of nonfinancial measures.[27] More than a decade has passed since then, and their recommendations have caught fire. The job of managers and accountants is to finish the return of relevance to management accounting. With that return, they not only lay the groundwork for the accountable organization, but they will enable companies to relink management and financial reporting. The numbers provided by management accounting can once again come first. These numbers and other important managerial information can feed financial reporting, in particular the broader set of information that accountable companies will want to disclose. Accountants and senior managers can then mount a corporate communications strategy to ensure that all stakeholders receive the information they need. This information includes a broadened uni-

verse of both facts and data to help outsiders, first, to evaluate past corporate performance and, second, to make projections about future performance.

Top financial officers play a special role. They must set aside the money and dedicate the people to complete this revolution in accounting, returning relevance to financial reporting. As they do, they will have to expand their role beyond stewards of the financial figures. They will become stewards of performance measures that allow line managers to factor financial, operational, and even social impacts into decision making. They must insist that the organization draw on the richness of a newfound universe of measures to voluntarily report performance to stakeholders.

Now is not the time for managers to suffer stage fright. They must take steps to begin building accountable organizations. With new corporate culture, governance, measurement, management systems, and reporting, they will become more productive, profitable, and innovative while boosting the standard of living and social well-being of the people with whom they do business. As a first step, they must assess the level of accountability in their own organization. As they do, they will probably find, as we show in the next chapter, that the level simply fails to come up to par.

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PART TWO

The Search for Wisdom

2

Facing the Crisis

Nobody runs a contest to grade companies on accountability. If someone did, the judges would find only a handful of firms vying for a blue ribbon. Most companies fall short of the ideal. Some don't even come close. The result? Both the company and its stakeholders suffer.

Just ask Dana Mead, an executive who knows firsthand both the rewards of accountability and the punishment from a lack of it. Mead joined Tenneco at the invitation of chief executive Michael Walsh in 1992. It was a time when Walsh, new himself, had a mandate for drastic action to turn the ailing conglomerate around. One of Walsh's earliest moves was to bring in his own team, including Mead, to run the corporation and put it back on the road to financial health.

Mead agreed with Walsh that the company had gotten complacent. Although business-unit heads committed themselves to financial budgets, corporate executives above them routinely tolerated missed targets if there was a good excuse. Corporate finance executives even allowed business-unit finance chiefs to lower targets during the middle of the year—without alerting the chief executive. The compensation system supported this blasé attitude, doling out stock "as long as you were warm, all present, and hadn't done anything egregious," says Mead.[1]

Tenneco's very existence was at risk. The "scissors curve," a graph of rising costs slicing upwards against falling prices, told the story of a company well on the way to bleeding to death. As the scissors closed, Tenneco lost $748 million from operations in 1991. Debt soared to a high of 69 percent of total capital by the end of September, just as the newly arrived Walsh was putting in motion a successful financial rescue of the company.

Accountability was, in a word, nonexistent. Neither Walsh nor Mead (who was named chief executive at Walsh's tragic death) could find measures that detailed the health of operations. They didn't have any control systems except for financial accounting. They didn't find forthright internal reporting that might have delivered insights for improvement or oblige commitment to change. "When you asked for information," says Mead, "it just wasn't there."

Tenneco's case is unusual. In 1992, it was a conglomerate of six different businesses, from automotive parts to shipbuilding. However, its crisis in accountability is not unusual at all. Many companies today run without the governance practices, performance measures, management control systems, and internal and external reporting that define the accountable organization.

In particular, a huge number of companies fail on two counts: managing performance with a broad selection of financial and nonfinancial measures; and delivering a detailed accounting of results to people inside and outside the organization. We closely scrutinize these two aspects of accountability throughout this book.

The failure in measurement stems from managers too often running their operations with measures devised decades ago, largely unadjusted for advances like quality management, just-in-time manufacturing, lean management, environmental management, and reengineering. Those traditional measures don't work in the new, more complex field of business today. Perhaps that's why 64 percent of companies, according to the Institute of Management Accountants, are experimenting with new performance measures.[2]

The failure in reporting stems from managers still keeping information too much under wraps—so much so that people across the company don't know what's going on or what's going wrong. Most managers refuse to reveal their performance numbers anywhere but behind closed doors, whether the data show they deserve a blue ribbon or the booby prize. Although some managers

are opening the doors on their performance data to a broader audience, most are still holding the opening to a crack.

THE POVERTY OF MEASUREMENT

Managers have brought the crisis in accountability down upon themselves. For six decades, they have increasingly confused the goals of management accounting and financial accounting. The two are simply not the same, even when they do overlap. Financial accounting is a machine tuned since the 1930s to satisfy the requirements of the SEC. It cannot serve as the wellspring of corporate performance measurement nor as the performance gauge. Accounts derived solely from generally accepted accounting principles, or GAAP, give a blinkered—financial-only—view of performance.[3]

Managers that look at financial ledgers alone are likely to manage like cartoonish, armchair general contractors. They will track construction of their new buildings by peering through a financial peephole in the fence. They will see the percentage completion of the work, the resources going in and out, and the quantity of steel piled up for raising new floors. However, they won't be able to gauge progress inside. When the lights go out, they won't know if their people forgot the wiring, tripped over a switch, or need more training in configuring lighting systems. Managers simply don't have the detailed financial and nonfinancial information to tell them what's going on, what their priorities should be, or how to do better next time. They don't have the data of accountability.

Financial Accounting

The source of weakness in financial accounting is also the source of its strength. Accountants have developed a system over the last 500 years to report financial numbers to people outside the company, not to managers on the inside. The system errs heavily on the side of compiling data that is *reliable,* like the amount paid for an asset. It thus often leaves out a lot of information that may be *relevant,* like the current value of real estate, intellectual property, and brands. It's a system perfected for a companywide counting of beans, a trustworthy record for outsiders peering in.

In fact, the system works pretty well to show investors how well managers are stewarding their capital; that is, not stealing it. It also works well to help tax collectors compute their share of profit for the state. However, the system has become a limited tool for giving shareholders and financial analysts the information they need for their judgments—the likely future performance of the company and its stock price. Some assets are valued at historical costs. Many are not valued at all. Information that might prove useful as leading indicators of performance goes unreported altogether.

Financial accounting also has limited value as a management tool. It actually hampers decision making because it turns people's attention toward historical figures. Thus, facing backward, people learn about the botched or beautiful work of the past, but they get a foggy or faulty reading of the future. The system essentially yields old weather records, unfit for dealing with the storm of business challenges ahead.

If managers could reliably extrapolate the future from the past, they might find the financial accounts more helpful, but even then they would find that the records aren't even available when they need them. Despite the speed at which accountants close the books these days, useful reports arrive on managers' desks weeks or months after the fact—too late to make mid-course corrections.[4] At Tenneco, nobody even knew week to week the performance of each division—shipbuilding, farm and construction equipment, automotive parts, packaging, natural gas, transportation, and chemicals.

Looking through the financial lens alone to make decisions has come to the point of being silly. Managers need to know if their strategy is working, and financial numbers rarely tell them. At Tenneco, Walsh and Mead initially had to look backwards through a single financial peephole called IBIT, or income before interest and taxes, to understand the problem. IBIT was the company's main measure of success.[5] What they needed instead was a way to gauge the success of their new strategy: to regain leadership in their markets through low costs and improving quality. They wanted to drive decision making, as Walsh liked to say, by looking through the windshield, not through the rear-view mirror.

IBIT just wouldn't do. To be sure, it did show how bad things were. In 1991, Tenneco's Case unit reported an IBIT of negative $1.1 billion, including more than $400 million in restructuring

charges, on $4.4 billion in sales. As Case was losing another $260 million from operations the following year, Mead even attempted to sell the division for $1, along with Case's $4 billion in debt. He found no takers. What Tenneco needed instead was a way to stimulate and gauge progress in executing a new strategy. It adopted a broad set of measures of everything from cash flow to environmental infractions.

Just one of Tenneco's new measures was the "cost of quality." In every business unit, to this day, managers work tirelessly to reduce these costs, which Tenneco calculates separately, as failure costs (scrap, rework, warranties, lawsuits) plus prevention and appraisal costs (inspection, testing, training, planning). The measurement was a key vital sign demonstrating the return of the company's health. In 1992, it cut $215 million in quality costs; in 1993, $246 *million more. In 1996, the company was still at it, cutting* $230 *million*, followed by another $236 million in 1997.

Just one mark of the value created was that in 1994 Tenneco sold 56 percent of the revived Case. The public offering raised $750 million. The cost of quality, along with the long menu of nonfinancial measures, had guided Tenneco away from the bite of the scissors curve. Since then, says Executive Vice President Robert Blakely, CFO since 1982, "We've taken a company driven on financial accounting systems to one driven on performance systems and forecasting."

Getting to full accountability through the financial accounting system fails for another reason. The accounting is based on scores of assumptions that may not reflect economic reality. Even the near-sacred earnings and returns figures may mask this reality. When the company carries real estate at 1950s prices, it overstates return on capital. When it recognizes revenue after shipping product to a distributor, as opposed to when the distributor ships to a customer, many people believe it overstates revenue. When a software firm capitalizes R&D, many people believe it misstates earnings.

Accountants may argue the details, but they agree that financial statements can offer alternative views of the truth. Take the hypothetical case of two essentially identical companies. One capitalizes most R&D. The other expenses all R&D. The balance sheets of the two will show wildly different values. One might have a book value

of 10:1; the other, 5:1. In the firm that writes off the R&D, managers no longer have to answer tough questions about the return on the investment in product development because that investment is not on the balance sheet; its expensing deflects many, possibly embarrassing, inquiries.

Of course, the bodies that set accounting standards provide a lot of choice in financial reporting in part because they want to allow companies to portray results in a way that best fits their businesses. The discretion allowed also increases the quantity of information companies supply because standards don't block inclusion of relevant data by specifying regulatory pigeonholes.

Still, for purposes of accountability, the ledger entries portray a variable truth, and that truth may change year to year, too. Plenty of accounting changes lie very much within generally accepted accounting principles. From one year to the next, companies can increase earnings by switching from accelerated to straight-line depreciation, by lengthening depreciable lives, by increasing assumed returns on pension assets, or even by reversing earlier write-offs.

The flexibility in accounting begs the question: Who is to say which numbers give managers firm footing to stand on when building the accountable organization?

The trouble raised by accounting assumptions is exacerbated by managers who give in to the temptation to manipulate financial results. Under intense pressure to deliver on year-, quarter-, or month-end budgets, they can delay spending to another quarter to help earnings in the current one. Who hasn't been asked to put off travel plans to help shine the upcoming numbers? Who hasn't pulled sales into a current quarter by offering customers irresistible deals? Who hasn't gotten caught in year-end sales-closing antics, not always closing deals at an acceptable profit?

Managers should not lull themselves into thinking that the practice of managing earnings goes unnoticed. In a harsh rebuke to managers and accountants, SEC Chairman Arthur Levitt took to the podium at New York University in September 1998 to scold companies for "accounting hocus-pocus." He assailed companies in particular for engaging in five kinds of "trickery," including inflating revenues and padding gargantuan write-offs for restructuring and acquisitions. He then promised new rules from the SEC to tighten accounting practices gone astray. "Too many corporate

managers, auditors, and analysts are participants in a game of nods and winks," he said.[6]

Levitt's crackdown stems in part from an undisciplined attitude by many business people toward holding the line on good accounting practices.

In a study of a regional group of accountants, respondents said they had few qualms about massaging the bottom line through operating-decision manipulation. They rated the practice of deferring expenditures by a month as a 3.38 on a scale of 4 (ethical) to 0 (unethical). They rated deferring expenditures into the next year as a 3.12. They even tolerated, to a lesser degree, practices that violate generally accepted accounting principles. They rated the deferral of the recording of supplies received to future accounting periods as a 1.71 on the same scale.[7] Referring to this kind of erosion in earnings quality, Levitt said, "Managing may be giving way to manipulation; integrity may be losing out to illusion."

Surveys suggest that Levitt is right even when it comes to the executive ranks. In answer to a 1998 *CFO* magazine conference questionnaire, 45 percent of respondents said they had been asked to misrepresent results. An astonishing 38 percent said they did so.[8] Apparently, neither accountants nor managers nor executives reject out of hand the finagling of numbers to improve the earnings report.

Management Accounting

Many companies have turned to their management accounting systems to bypass the limitations of financial accounting. Some of them have developed best practices that give them a firm foundation for true accountability. We discuss them in Chapter 4 and in the second half of this book.

However, many companies have not gotten beyond the crisis in management accounting that crept into place early in the century. That is, they use management accounting as not much more than a data-gathering device for determining product costs and compiling external financial accounts. As Thomas Johnson and Robert Kaplan argued in 1987, management accounts are driven by the cycle and procedures of financial accounting.[9] The information is most useful for tasks like valuing inventory and aggregating costs across the company. It is an incomplete basis for measuring performance.

Any company that has not radically changed its management accounting risks finding it produces problems similar to those created by financial accounting. The two most critical problems are prodding managers into, first, an incessant financial focus and, second, a near total reliance on historical, or lagging, indicators for decision making. The product and service costs that managers receive, the meat and potatoes of managerial accounting, often reveal little about the nonfinancial factors of performance that create costs, like complex product designs or defective customer service. The cost data help managers keep the financial score but not necessarily how to improve their long-term batting average.

Unfortunately, the data from traditional cost systems are often just plain wrong—not a little wrong but wildly so. A classic example is the case of Tektronix's circuit board division in Forest Grove, Oregon.[10] In the late 1980s, the cost accounting system nearly ran the division out of business. Sales of the unit rose briskly, breaking $50 million, but profits tumbled. Managers from sales, marketing, engineering, manufacturing, and finance could not agree on the root cause.

The circuit board division had already adopted just-in-time techniques, statistical quality control, and total quality management. Inventories were shrinking, quality rising, and delivery improving. The cost system, calculating standard costs, even said margins were just fine. Yet, as the plant manager at the time, Gene Hendrickson, later lamented, "the more we sold, the more money we lost."

Exasperated, Hendrickson adopted activity-based costing (ABC), which guided the plant to profits four times the industry average. Using ABC, accountants assigned overhead according to its actual usage by product, not, as in standard costing, by averaging costs across the plant. The retabulation revealed that one printed circuit board the division sold for $1.00 cost $4.30 just to manufacture. Including overhead, it cost a staggering $20.30. Yet, the standard cost accounting system's numbers were a fraction of that—just $0.67. The division was losing nearly $20 on each such unit sold.

Why such a wild difference in accounting? The board was made in lots of one or two, which consumed, in some cases, the same amount of overhead time as lots of thousands. The per-unit overhead cost of small lots was actually huge. Most debilitating was that more than half the division's product line sold in small (under-

costed) lots. So faulty product costing was helping drive the division toward extinction. Tektronix was caught in a death spiral, so long as it profited only on large (overcosted) lots. By using ABC, the unit could calculate not just product costs accurately but customer costs as well, leading Tektronix to sell only profitable products to profitable customers.[11]

Even when cost systems do provide accurate measurement data, they can still distort decision making, eroding the basis for full accountability. A classic example of this problem is that of Analog Devices, which recognized long before other companies the pitfalls of a dominating focus on financial accounts. Now a $1.3 billion Norwood, Massachusetts, integrated circuit board maker, Analog had grown by an annual 25 percent into the mid-1980s when suddenly growth slowed to less than 10 percent. Analog pinpointed one problem: too low a yield, or too many scrapped chips. So, like Tektronix, it adopted total quality management.

Analog found right away, though, that the signals from the accounting ledger, right or wrong, encouraged behavior that clashed with quality efforts. Standard cost accounting, for example, would goad people into building too much work-in-process inventory. That slowed down manufacturing cycle times and lengthened lead times. It also angered customers. The cause? A desire by managers to reduce the cost of goods sold (with the help of the averaging of standard cost accounting) and thus increase margins and profits at quarterly reporting time.[12]

Another tough problem is that traditional financial measures would encourage people to ship high-value orders early, even if that meant shipping low-value ones late. Art Schneiderman, then vice president of quality, polled twenty of his peers in 1986, asking those who regularly dealt with customers what they heard when angry customers called. The answer, chastening, was predictable: "Where's my order!?"[13]

Time and again, Analog found, financial figures are too late to act on, too distorted, too encouraging of the wrong behavior, too lacking as leading indicators. In short, as many companies have found, financial figures alone aren't an adequate foundation on which to build an accountable organization, especially when linked to pay. Executives who rely on traditional financial figures risk making decisions they will kick themselves for later, like dropping the wrong

product lines and cutting staff rather than cutting costs from poor quality.

The lesson is that companies that depend on financial accounting and traditional management accounting systems are in crisis because they are missing the first element for making the accountable organization: relevant and comprehensive measures of performance. Without systems that extend beyond the financials to nonfinancials and that accurately tally product costs, few managers or executives can deliver a maximum of value to shareholders, customers, or anyone else.

Managers widely recognize the problem today. In a study by Deloitte & Touche, 45 percent of companies said their performance measurement system had a neutral to negative impact on long-term management. What's more, respondents who reported the least satisfaction with their performance measurement systems used financials more intensely and used fewer nonfinancials than did respondents who reported more satisfaction. Little surprise that 65 percent said most of their measures came from the current-year financial results.[14]

Analog chief executive Jerry Fishman began wrestling with the inadequacy of the financial accounting systems back in the late 1980s when he was executive vice president. Once the distortions in the system became clear, he stumbled upon the next managerial problem. Top managers were arguing about priorities in the corporate agenda. They were asking, Which comes first, financial or nonfinancial goals? "Your job," Fishman told Schneiderman, in a phrase that captures the challenge we address in the second half of this book, "is to integrate them."[15]

THE DROUGHT OF REPORTING

When managers work with the right numbers, and even integrate them, many still face a crisis in accountability. The main cause is a culture of confidentiality. Managers worry so much about letting go of information that could benefit competitors—or litigators—that they don't release information that will benefit their own organization. Their attitude is, if in doubt, don't give the information out.

The practices and behaviors that protect legitimate company secrets can run amok. People may believe that hoarding data yields

more benefit than sharing it. They may habitually keep their information to themselves, sensing that an ace up the sleeve can trump a political foe. They may use the data to hide troubles, manipulate others, or build power. They serve themselves at the expense of the organization.

This is partly a legacy of command-and-control management. Managers once amassed information only at the top of the hierarchy. They squelched dissemination of critical performance data. Today, however, without ample and credible information, employees can't accelerate continuous and breakthrough improvement. They can't win the trust and loyalty of people outside the company, the customers, shareholders, suppliers, and others they depend on to conduct business.

Reporting on the Inside

In few companies today do managers share their measures of success widely. Some "open-book" companies are the exception, at least in sharing financial data.[16] AES Corporation, the $835 million independent power producer in Arlington, Virginia, goes to an extreme: It has long given employees so much information that all are classified by the SEC as insiders. AES also annually surveys its employees' opinion of company values—of integrity, fairness, social responsibility, and even fun. Until 1994, when AES grew too large to report comparable data across divisions, it even published the survey results in its annual report.[17]

But few large companies circulate financial and nonfinancial data throughout the organization, from team to team, or division to division. Even if they have the systems to do so, they don't. They consider the data too sensitive.

One company that saw the mentality of sealed lips and secrecy drag down performance was CIGNA Property & Casualty. Before Gerry Isom took over as president in 1993, the company operated without any means of broadcasting the critical measures of its success around the company.[18] At the time, the company was suffering a financial crisis. Hit by claims from the Mississippi and Missouri River floods, Los Angeles riots, environmental cleanup, and Hurricanes Hugo and Andrew, the Property & Casualty (P&C) unit lost $1 billion between 1990 and 1993. Its combined ratio in 1992 was 129 percent—it was shelling out $1.29 in claims for every $1 coming in.

The poor circulation of data was hardly the only cause, but Isom noted some of the behavior it prompted: "While everybody's intentions were pure, a strong dynamic had developed between the divisions and corporate. In particular, the mission of P&C's financial staff had evolved into an ambiguous one. On one end, they were tasked with supplying P&C's management with the necessary financial information. . . . On the other, they'd developed the habit of filtering the information they distributed inside, and leaking selected other information to corporate, unbeknownst to the P&C management team."[19]

The information Isom wanted spread around for better decision making, strategy execution, and organizational learning had become a commodity for squirreling away and parceling out. The filtering of information complicated Isom's goal of providing a strong, consistent message that would align the efforts of everyone in the organization. It also blocked organizational learning, a capability Isom believed was necessary to succeed with a new strategy of specialty insurance. The tight-fisted treatment of information meant that employees didn't even know precisely how their performance was being measured. Nor did they see clearly how to fit their efforts into the strategy.

Poor internal reporting contributes to the crisis in accountability in other ways. One of the most important is in reducing commitment to delivering results. To gain the commitment of people, teams, business units, and functions, managers need peer-reviewable targets, measures, and results, but many organizations keep the goals and results of business groups at all levels behind closed doors. At both CIGNA Property & Casualty and Tenneco, none of the business-unit heads knew the results of their peer-level executives—until the changing of the guard in the early 1990s.

Disclosure on the Outside

Although many companies fall short of full accountability by failing to share performance measures widely within their organizations, even more fall short by failing to share them outside. By operating with poor external disclosure, companies count themselves out of the rich feedback that spurs learning. They complicate informed decision making by financial analysts, shareholders, customers, suppliers, and others with whom they interact. They forgo

the opportunity to develop enduring stakeholder loyalty, an increasingly valuable edge in business today.

Most companies try to fill the information gap with public-relations fodder, but PR is a flimsy tool to engage stakeholders in making decisions in the company's favor. Moreover, PR often comes with an implication that the company is stonewalling, hesitant to come clean with all available facts. By relying on PR alone, executives risk losing that most valuable commodity: credibility. Something more than PR is needed to engage the hearts and minds of the people who provide low-cost capital, talented labor, steady business, and reliable alliances. Hard data, fresh from the company's data warehouse, is that something.

Few companies provide a complete report of performance information. Surveys spanning two decades show that even in the publication of annual reports, the key document portraying firm performance, companies don't come close to satisfying investors. Only 21 percent of investors, surveyed randomly, believe the annual report is "very useful." The good news is that figure is up from 14 percent in 1973, but the figure is still appalling. What business in America would consider a key product successful if only one out of five customers liked it?

The survey further shows that even the financial statements don't please the customer. Nearly one out of three investors still has trouble understanding the balance sheet and cash-flow statement—at a time when the cash flow has become one of the most trusted measures in the report. More than a third of the investors surveyed wanted more explanation of the balance sheet and cash-flow statement and more than a quarter wanted more explanation of the income statement and management discussion and analysis.[20] They also wanted more disclosure of forward-looking information that would help them to make better forecasts of future corporate performance.

With the awful ratings, you would think business would declare an emergency—and assign a crack team to engineer a new product. However, many corporate finance chiefs fight new disclosure requirements every step of the way. They have greeted recent Financial Accounting Standards Board (FASB) proposals on derivatives exposure, stock-options costs, and a more complete earnings figure called comprehensive income with disdain. Compromised rulings

have forced many critical facts into obscure footnotes. The result is that companies now portray some huge liabilities in their financial statements as having no cost at all. Such a distortion is not worth the divot thus whacked from management credibility.

A pair of reports in 1998 brought to light, for example, the mountainous liabilities companies have accrued as they have doled out employee stock options. The more conservative report, by Bear Stearns, calculated that had DuPont, for example, expensed options costs like other pay, company net earnings in 1997 would have taken a hit of 8 percent.[21] Had Silicon Graphics done the same, net earnings would have evaporated. Factoring in the rising value of unexercised options, Smithers & Co. Ltd. (London) came to even more alarming conclusions. The one hundred largest publicly traded U.S. companies, concluded Smithers, would have reported, as a group, 34 percent lower earnings in 1996 if all options costs had been expensed.[22]

A survey of Wall Street's star analysts revealed enormous dissatisfaction with company disclosure. Thirty-five percent of these respected analysts have trouble understanding footnotes; 18 percent have trouble with the statement of cash flows. Even analysts who say they understand the statements feel poorly informed: 55 percent want more explanation of the footnotes; 34 percent want more on the cash flows.[23]

The reaction of analysts to other parts of the annual report isn't much better. For example, 49 percent would like more explanation in the management discussion and analysis—including data on product-line profitability, budgeted year-ahead income statements, earnings forecasts, and explanation of strategy.[24] The analysts aren't fooled by inconsistent approaches to reporting year to year, either. Half say they believe companies purposely write in obscure language when they aren't doing well. They say they want full disclosure in both good times and bad.[25]

Annual reports leave plenty of room for management to volunteer better information. You might think managers would grab the opportunity to improve a faulty information product. Yet, few do. In interviews with twenty-five of the most influential institutional investors in Europe and the United States, performed by Shelley Taylor & Associates in 1998, seven of ten investors said they consider clearly stated objectives and their comparison with actual achieve-

ments very important. Yet, in a concurrent study of annual reports for 100 of the world's largest firms, only 76 percent clearly state objectives, and a mere 24 percent showed results against objectives.

These institutional investors also said they are intensely interested in disclosure of forward-looking information, but in only 37 percent of the annual reports did companies divulge forward-looking information including earnings forecasts, and in only 41 percent did they disclose, in financial-statement footnotes, planned expenditures.[26] What's remarkable is that not even the people most managers feel ultimately responsible to—the owners—are satisfied with the information they receive on their share holdings.

In the light of history, perhaps this gap between what investors want and what they get makes sense. After all, the SEC and FASB have over the years dictated most disclosure practices. Managers have understandably come to view disclosure as an act of compliance, which they associate with a storm of red tape and strong-willed bureaucrats. They have thus begun to develop a compliance mentality. Disclosure gets lumped into the reviled category of business activities, like taxes, managed to meet the letter of the law. It is no surprise that in a 1998 survey of 308 large companies by the American Society of Corporate Secretaries 44 percent reported they divulge no more than what is legally required.[27]

The crisis in accountability becomes particularly acute when it comes to disclosure of nonfinancial information. At a time when many companies crank out reams of quality, customer satisfaction, employee satisfaction, turnaround time, environmental management, equal employment, charitable giving, employee treatment, and other data, they spend too little time examining how they could use the data for gaining an advantage through both internal reporting and public accountability. They should be managing disclosure as a competitive opportunity and should start by making a more transparent communications strategy a critical component of corporate strategy.

Managers may pooh-pooh the value of further nonfinancial disclosure. They may obsess over the costs and risks—of data processing, paperwork, potential litigation, and loss of trade secrets—but they will find they are not meeting the demand for this information any better than the demand for better financials. In 1997, Ernst & Young's Center for Business Innovation, in

Boston, studied investment preferences of 275 portfolio managers. They found that decisions are 35 percent influenced by nonfinancial factors. A company's ability to attract and retain talented employees, for example, ranked fifth in a list of twenty-nine factors investors use to pick stocks.[28]

A raft of such data sought by outsiders, however, remains locked in the vault of corporate confidentiality. Managers should not stop short of achieving full accountability simply for want of fuller disclosure, of either financial or nonfinancial items. The few companies that do release more data, as we will see in later chapters, are breaking new competitive ground.

THE SEASON OF DISCONTENT

Solving the crisis in accountability has become more urgent in recent years. The competitive pressures are only half of it. Pressures from stakeholders are the other half. Not only are these outsiders dissatisfied with corporate accountability, but they are campaigning like never before to improve it. They are striving to part the corporate veil, with whatever tools they can muster, whether managers like it or not.

Most executives misunderstand the gathering forces arrayed against them. They fail to sense the full scope of the discontent. They let marketeers field the gripes of customers. Investor-relations people take the heat from shareholders. Local line managers catch the criticism of communities. Various staff handle the stones hurled by public-interest groups. They allow the many extremities of the corporate body to absorb the multiple pinpricks of pressure. The company consequently treats many demands for greater accountability in isolation and as nuisances.

What senior managers should grasp is that the pinpricks are symptoms of one overarching trend: the growing belief by company outsiders that corporations should provide a far better public accounting of performance—and the growing commitment by those outsiders to use everything from the power of persuasion and peer pressure to hungry journalists and sympathetic lawmakers to press their case. Managers who view these pressures in isolation make a mistake. They should view them, and handle them, as one.

Outsiders today simply believe they have a right to know what is happening inside corporations. No company can escape the rising tide of external activism, whether from shareholders or other constituencies, to examine the inner workings of corporations large and small. A look at some of the activism facing companies today reveals how the inexorable growth of pressure for greater accountability is forcing many managers to change the way they manage.

Regulatory Heat

Regulators remain a prominent force for greater accountability, whether the Occupational Safety and Health Administration, the Environmental Protection Agency, or any other federal, state, or community agency. If not by the force of law, they press their cases through the force of will.

No agency better exemplifies the regulatory posture toward disclosure than the SEC. In opening a speech at the University of Virginia, SEC Chairman Arthur Levitt quoted Samuel Johnson, who said, "Where secrecy or mystery begins, vice or roguery is not far off." Levitt maintains that it was precisely to protect investors from the danger Johnson observed that the SEC was created in the aftermath of the 1929 market crash.

Levitt, fond of reminding people of the SEC's historical mission, quoted Joseph P. Kennedy: "Publicity," said Kennedy in his very first speech as the first chairman of the SEC in 1934, "will be an important element in the new conditions, publicity, not of an occasional nature, but regular and informative. It will not be enough for a new enterprise to be candid in its original prospectus; it will supply its investors, from time to time, with publicity of such a nature that all will be as well informed as any individual could be."[29]

The SEC never considers that mission quite fulfilled. Levitt and other commissioners remain on the lookout to make disclosure ever more informative. Steven Wallman, commissioner until late 1997, even laid out a new, radically expanded approach to disclosure. "The purpose of accounting and financial reporting is to provide information that is useful to investors, creditors, monitors, and others—increasingly including employees and major suppliers and customers—in making investment, credit, monitoring, and other decisions."

He then outlined disclosure that would suit this cast of characters. He suggested data the likes of which few firms would consider reporting today: off-balance sheet intangibles (for example, the value of brands), customer satisfaction (as in J.D. Power survey results), and "intellectual capital" (for instance, the value of a trained workforce).[30] This proposal has not been adopted, but whatever its merit, it reveals an entrenched principle of regulatory thinking, a principle not just alive in the SEC but in agencies across the land: More disclosure is better disclosure.

Accountants on the Move

The accounting profession, represented by the American Institute of Certified Public Accountants (AICPA), contributes to the pressure for accountability in a different way. Long worried about the growing irrelevancy of traditional financial statements, AICPA leaders felt in the early 1990s that they had to make some recommendations for change. After all, the group is the main think tank and standards counselor for public reporting practices. So in the early 1990s, the AICPA tapped Edmund Jenkins to lead a committee to figure out what to suggest. Jenkins, now head of the FASB, came back in 1994 to suggest that companies throw open the door on disclosure.

The so-called Jenkins report ran 200 pages, reflecting what users of financial statements wanted. Backing it up was a 1,600-page database of research, mainly results from a Lou Harris survey of 1,200 investors and creditors, discussion groups with investors, and analyses of investment documents. Among a deluge of suggestions in the report, the Jenkins committee prescribed a new model for business reporting. It called on standards makers to require "high-level operating data and performance measurements—which help users understand the linkage between events and their financial impact on the company and the factors that create longer-term value."[31]

The report ignited a firestorm of criticism. Some observers forecast a short shelf life and quick burial, but the AICPA formed a committee to follow up on the recommendations. In early 1997, a sister committee, studying assurance services, chaired by KPMG partner Robert Elliott, released a report strongly endorsing the Jenkins reporting model.[32] In 1998, the FASB, headed by Jenkins,

voted 7–0 to take up a project to pursue the recommendations. The Jenkins report, though temporarily a sleeper, hardly died.

Today, work continues behind the scenes to develop new, expanded, high-quality reporting practices. Businesses can safely bet that they will feel unceasing pressure for greater transparency, mandated or voluntary. Accountants will increasingly want to fulfill key recommendations of the Jenkins committee. Among them,

- "Provide more information about plans, opportunities, risks, and uncertainties.
- "Focus more on the factors that create longer-term value, including nonfinancial measures indicating how key business processes are performing.
- "Better align information reported externally with the information reported internally to senior management to manage the business."[33]

Clout of the Customer

The clout of customers may yet overwhelm the pressures from either regulators or accountants. Although customers have not risen to a powerful force in opening the disclosure doors in many industries, managers can hardly afford to ignore them. In a sign of what's to come, consider the health-care industry. In their dealings with everything from small hospitals and physicians' practices to giant managed-care organizations, health-care customers in many regions have already gained so much power that they are, in effect, issuing orders on what, when, and how health-care organizations should disclose performance data.

The irony is hard to miss. An industry maligned for managerial backwardness has taken what appears to be a five-year lead over the rest of industry in measuring and reporting to customers all kinds of data—quality, customer satisfaction, administrative performance, and so on. As far back as 1993, managed-care giant United HealthCare, whose story we tell in Chapter 4, reported such detail as administrative costs per member and appointment wait times.

How has it happened that an industry of managerial laggards jumped to the lead? The answer is equally ironic. Coalitions of business customers, often with poor disclosure records themselves,

banded together to wring nonfinancial information from their health-care suppliers. Hospitals, physicians' groups, health-maintenance organizations—they have all been taking a crash course in measuring and reporting performance to comply with the ultimatums of their customers.

Consider northeastern Ohio, around Cleveland, as just one example of the forces at play. In 1989, Cleveland's biggest employers formed the Cleveland Health Quality Choice Program (CHQCP). Every Cleveland hospital that valued these companies' business had to measure and report mortality rates; lengths of stay; patient satisfaction; and outcomes for medical, surgical, obstetrical, and intensive-care patients. The hospitals had no choice. To this day, they prepare a twice-yearly report card, which helps steer patients to the highest quality, most efficient health-care providers.[34] Not only has the CHQCP created accountability, it has increased patient satisfaction and sharply reduced mortality rates.

Managers who don't feel they should get ready to take advantage of (or avoid getting hammered by) such customer power should note how the CHQCP's maneuverings played out. When the first round of data was released in 1993, the numbers proved that hospital quality varied widely. Some hospitals that charged the most even offered the poorest results. Within a year, by the release of the third report in spring 1994, health-care managers could plainly see that the power of publicly disclosed numbers would restructure the industry.

Health-care customers, principally health-maintenance organizations, threw their old vendor arrangements out the window. In 1994, MetLife announced it would pare its hospital network, redirecting its 70,000 Cleveland-area enrollees from twenty-eight hospitals to just eleven.[35] Aetna Health Plans of Ohio created a subnetwork of eleven (of thirty-two) hospitals, telling its 400,000 members that they would get a 25 percent discount for using the smaller, higher-quality network.[36] One local physician network shifted 275,000 patients from one four-hospital group to another.[37]

The story of Cleveland, where some hospitals saw their business plunge overnight, is being repeated around the United States. Doctors, hospitals, and health networks have been offered deals they can't refuse—measure and report or risk losing hundreds or thou-

sands of patients. The stakes are huge. Some buyers' groups represent the Goliath of all customers: the federal government, the administrator of Medicare and Medicaid, known as the Health Care Financing Administration.

Managers in other industries may pass this off as a one-industry event. That would be a mistake. Customer power is growing everywhere. When customers gain a critical mass, they will often demand hard numbers. Their collective muscle can pry the doors off the lockbox of proprietary corporate performance data. As just one other example, note how outraged consumers, with the help of celebrities, are working to publicly expose corporate labor-practice data. Shoppers want assurance they aren't supporting child labor or sweatshops. What does this mean in the future? As an indicator, two-thirds of Americans, according to an Ohio State University survey, favor labels that tell consumers clothing was made by socially responsible manufacturers.[38]

A decade ago, few health-care executives would have dreamed that they would now be baring their operational soul. Now, in a development other industries should heed, full accountability has become so much a part of standard industry practice that the Joint Commission on Accreditation of Healthcare Organizations (JCAHO)—the premier accrediting group for the nation's hospitals—launched a program in 1997 requiring hospitals to report at least two quality measures (of their choice). Starting in spring 1998, the hospitals that don't report at least two can't gain accreditation. The requirement gradually rises to twelve measures by December 2000.

In a sign that the JCAHO plans to push the accountability trend forward, it also gave health-care managers the option of going beyond compliance. Hospitals can step into the limelight by joining the elite ORYX PLUS program (the program's name, not an acronym). ORYX PLUS hospitals will start immediately reporting to JCAHO at least ten measures from a standardized list of thirty-two.[39] They can then release, with the seal of approval of the JCAHO, the broader list of figures to customers. The ORYX PLUS program will give participants a huge advantage over their competitors, especially because the JCAHO will display data that compares individual hospitals with national averages.

As the JCAHO says, those hospitals adopting ORYX PLUS will "quickly become recognized by consumers, employers, payers, and government bodies for their commitment to self-evaluation and accountability through their willingness to share performance information with the public."[40] We can predict that health-care organizations failing to follow the leaders will put themselves at a marked disadvantage. We can also speculate that those industries that go too slow in recognizing the rich returns of investing in accountability may handicap their future competitiveness.[41]

Interest-Group Intensity

Corporate watchdog groups are always ready to raise the alarm of a crisis. Forever loyal to their programs, they nip continuously at the corporate conscience for more accountability. They have such power and sophistication that, today, companies ignore them at significant cost. These organizations include not just the citizen-action groups that like to advance their cause via raising a public ruckus but also the new breed of organizations that sit at the table with business people and *negotiate* for greater accountability.

Consider the California Reinvestment Committee (CRC) in San Francisco. CRC, which monitors banks' reinvestment of deposits in local communities, has signed oversight agreements with six California banks. These letters of understanding, executed by, for example, the chief executives at Bank of America and Wells Fargo, detail reinvestment pledges, like how much multifamily housing they will invest in and in what cities. CRC meets with bank officials twice yearly and requires a performance report and verification of progress. Over the last decade, CRC has gone so far as helping banks meet their goals. At one time, it steered Wells Fargo into using the low-income housing tax credit profitably to create what has become a multimillion-dollar low-income housing loan portfolio.[42]

Consider the Coalition for Environmentally Responsible Economies (CERES), which lobbies hard to get companies to provide an exhaustive, voluntary public report on environmental performance. In its early years, CERES enrolled a contingent of small do-gooder firms. Today it targets and enrolls the biggest names in business, from Sun Company and Polaroid to General Motors and Coca-Cola. The CERES commitment requires companies to answer

a tough, 110-part questionnaire that portrays every aspect of their environmental performance, from waste recycling to energy consumption.[43] "We really feel like we're baring our soul in answering those . . . questions," says Philip Hillman, head of environment at Polaroid.[44]

Consider the Interfaith Center for Corporate Responsibility (ICCR), an association of 275 religious groups that together hold $90 billion in assets. The ten staffers at ICCR, while wearing the hat of social activist and exerting the influence of monied shareholder, raise a wide array of issues, from environmental affairs and equal employment opportunity to hiring in Northern Ireland and doing business in Burma. ICCR has convinced 150 companies to release their equal employment opportunity data, triple the number of ten years ago. In one case, that of Schering-Plough, a single meeting prompted executives to hand over the desired document.[45]

When the powers of persuasion hit resistance, ICCR staffers don't hesitate to turn on their shareholder activism. In 1998 alone, ICCR-related shareholders sponsored 158 shareholder resolutions at 114 companies. At Con Agra and Barnes & Noble, for instance, these groups filed resolutions calling for disclosure of the equal employment opportunity numbers, essentially the data supplied to the government in EEO-1 reports, often held secret from the public. ICCR also filed 41 resolutions calling for adoption of the CERES principles.[46]

The pressure exerted by groups like the CRC, CERES, and ICCR on individual companies sends waves of influence toward other companies that shy from taking a seat at a table with a public-interest group. Amoco, for example, prodded repeatedly to adopt the CERES principles, declined, but the influence of CERES still left its mark: Amoco sponsored the Public Environmental Reporting Initiative (PERI) with nine other companies (including DuPont, Dow Chemical, and Polaroid). The industry-led effort created a parallel standard for environmental reporting. From 1992 until its acquisition by British Petroleum, Amoco reported environmental performance against the PERI guidelines, disclosing an unprecedented amount of information.[47] Action by Amoco and similar firms demonstrates that public interest groups have gotten managers' attention, convincing many managers that disclosure counts more than ever.

Pension Power

As in most stories of power and influence, one character stands out as the 800-pound gorilla. In the accountability story, that character is the institutional money manager. These managers together control such vast capital that their wish often carries the weight of command. The most active of these managers today are the public pension-fund managers, whose story we tell in the next chapter. Suffice it to say for now that a few pension gorillas can bring incredible urgency to top managers' efforts to create better accountability.

With the voice of the pension-fund manager added to the mix, corporate managers will find that stakeholder calls for full accountability are calls they cannot ignore. Even if they choose not to build an accountable company for internal reasons, as a way to make their operations more competitive, they may well have to build one for external reasons, as a way to make their operations acceptable to outsiders. That is part of the price they pay for access to labor, capital, and product markets. That is also part of the price for their license to operate in a society that views business as intertwined with other social institutions.

LOSING THE LEAD TO OUTSIDERS

Because few managers comprehend that a crisis of accountability engulfs them, even fewer have acted quickly to turn the crisis into opportunity. Just the opposite. Other organizations have taken the prerogative to specify the terms of the corporate accountability equation. In case after case, independent groups have cropped up to measure and publicly report corporate performance. To the extent that companies could gain advantage by reporting for themselves, especially with audited figures, managers have largely lost the opportunity forever.

Among the independent organizations grabbing the lead is the Families and Work Institute. In the *Corporate Reference Guide,* it rates company performance in three categories to produce a "family-friendly index."[48] *Business Week* similarly grades more than fifty companies on family friendliness.[49] Other organizations taking the lead are Wichita State University and the University of Nebraska–Omaha, which publish annual airline-quality ratings, based

on data the airlines report to the government.[50] University of Michigan's Business School and the American Society for Quality Control rate quality at more than 200 companies on a 1–100 scale.[51] The National Association for the Advancement of Colored People (NAACP) issues report cards on the employment of African Americans at hotel chains, giving only the best an A, expecting the grades to swing traffic to the more diverse hotels.[52] *Fortune* magazine, working with the Council on Economic Priorities, even inaugurated in 1998 a list of the fifty best companies for Asians, African Americans, and Hispanics.[53]

Of course, most stakeholders who are trying to gauge the mettle of a company prefer such independent measurement. Still, the emergence of so many rating groups sends a two-part signal that managers should heed: (1) People want more decision-making information than companies produce today, and (2) companies have been too slow to produce it for either insiders or outsiders. It's a simple message, really. It sums up the root cause of the crisis in accountability.

The challenge for managers is to do something about this crisis. In the next four chapters, we explore what companies *are* doing about it: revamping governance, devising new measures, revitalizing management planning and control, and expanding reporting. In Chapter 3, we start at the top of the power pyramid, looking at efforts to reform the governance of the corporation.

3

Calling for Governance

The drama of the accountability crisis has not yet reached a climax at many companies, but, like most dramas, it has already put one set of people under the bright lights. These are the people that most outsiders view as the power brokers responsible for the problem, the chief executive and the board of directors.

The notion has emerged that a corporation without an active, independent organ of supervision cannot be fully accountable. That is why companies have begun actively experimenting with the first element of corporate accountability, governance. (See Figure 3-1.) They are concluding that the board must comprise a set of directors who are completely independent, who ensure the accountability of the chief executive. Those directors must run the board with strict, new governance practices, which ensure their accountability to outside constituencies.

At a special meeting of shareholders on July 2, 1997, Dennis Kozlowski, chief executive of Tyco International, showed just how much good board governance counts in improving decision making and strategic execution. Kozlowski knew his audience wouldn't be entirely happy on that day. Many shareholders thought that, in the interest of empire building, he was asking them to vote for a deal from tax hell, namely a proposal to acquire

Figure 3-1
The First Element of Accountability: Governance

burglar-alarm giant ADT, in which they would have to pay capital-gains taxes on their Tyco stock.

Some shareholders recoiled. Long-term shareholders would have to pay big taxes, because the stock had doubled in just the previous two years. The reason for the taxes was that in buying ADT as a white knight, Kozlowski had arranged a complex transaction in which Bermuda-based ADT would legally be acquiring Tyco, the Exeter, New Hampshire–based conglomerate, which makes fire systems, underwater cables, medical supplies, circuit boards, and packaging.

The chief executive of the $18 billion firm (after recent acquisitions of U.S. Surgical and AMP) admits that the board didn't warm up to the deal at first. Even when he flew to New York to win them over in a special meeting, the debate lasted ten hours, about seven hours longer than he expected. He argued the merits of the deal, of course. The combination would make Tyco the largest fire and security business in the world. The company would expand operations to fifty countries. Tyco would acquire 1.8 million ADT

customers. He assured directors that the deal, detailed in a 200-page proxy statement, would lift the stock price significantly. Still, recalls Kozlowski, "There wasn't a director who didn't question [the deal] and agonize over it."[1]

This is why, at the July meeting, Kozlowski relied on more than the suggested merits of the deal to convince shareholders. He relied also on his and the board's record of accountability for performance. Long-time Tyco director Philip Hampton was called on to defend the plan. He reminded shareholders that all seven directors owned stock (all but one owning more than 10,000 shares). He said the board would take the tax hit along with everyone else. He further proposed that if anyone in the room could suggest a better way for Tyco to take over ADT, the board would delay the vote.

At many companies around the world, getting the board to take such an active, objective oversight role has taken center stage as a means to create greater accountability. Strict board governance practices, the thinking goes, will reassure company outsiders that the board has the processes in place to ask the right questions and to monitor management effectively. Such practices help convince naysayers that executives and directors will act first to fulfill their obligations to shareholders and other stakeholders, and not to themselves. They reassure outsiders further that when the going gets tough, the company won't suffer from one of the root causes of the accountability crisis: a board that does the chief executive's bidding as opposed to a chief executive who does the board's bidding.

At Tyco, shareholders could look to a history of strong oversight to reassure them. Since 1992, the board has run itself according to principles that stimulate decision making independent of the CEO. Hampton, for instance, was the formally designated lead director. He had run regular board sessions without Kozlowski. He gave the chief executive his annual review. He evaluated each board member's performance.

So the comments by Hampton, a holder of 25,000 Tyco shares, carried a lot of weight at that July meeting. Shareholders came into the meeting with a respect for the legacy of accountability and performance of the CEO and the board. Although nobody can say how much this legacy contributed to the vote, shareholders voted to go ahead with the ADT deal. The deal worked as Kozlowski promised. After its consummation, Tyco stock rose steadily from about $60 to trade in the mid-$80 range within three months.

Of the four ways companies are pursuing full accountability—by means of governance, performance measurement, control systems, and reporting—governance has received the most visibility in recent years. How strongly it figures among the four components of full accountability is arguable. What is certain, however, is that modern governance practices like those at Tyco inject a huge measure of shareholder confidence into the decision making of management—confidence that corporate bosses and their boards can use to their advantage.

THE BANKRUPTING OF GOVERNANCE

Changes in corporate governance like those at Tyco have come in response to a tradition of board management that had gone bankrupt. *Ingrained and abused, that tradition had come to fail in exacting* accountability from company executives. Up to the late 1980s, many chief executives had come to routinely stuff boards with friends, family, business associates, and company executives. The directors were the people the boss lunched with, sent holiday cards to, hired to do taxes. All this coziness compromised the directors' ability to take a hard look at performance.

The board, in concept, comprises a panel of objective overseers.[2] These overseers counsel corporate managers and monitor performance. However, few directors proved they could adequately fulfill that role until recently. They weren't active counselors, vigilant monitors, or skeptical judges. Most dined on the information fed to them at the boardroom table by chief executives. They digested the data on their plate but never called for more. They certainly never stomped into the kitchen for answers. So they had no means to gain insights for hard-edged dialogue over the direction of the company.

Boards became—and many still are—the sugar daddies of chief executives. This is essentially what Adolph Berle and Gardiner Means said would happen. In their classic 1932 book, *The Modern Corporation and Private Property*,' the two economists predicted how power would shift within the company as ownership splintered into thousands of slivers divided among small, powerless shareholders. Top executives would hold all the power. The company bosses would become "princes of industry," and the princes would make decisions in their own interest, not in the shareholders'.[3]

Who could or would stop them? Certainly not the small shareholders. If they didn't like what was going on, they would sell. Certainly not the board members. Handpicked by the chief executive, they remained loyal to the company boss, cowed by pay and pensions. They had little at stake. Many directors didn't even own stock. Remarkably, directors' wallets were free from hurt if they failed at their sole job—acting as fiduciaries to steward and grow shareholder capital.

The board had become impotent. It was not so much a question of people's competence as it was a question of a derelict governance process. Even if stuffed with talent and led by a top-flight chief executive, the board couldn't contribute credibly to assuring accountability. If performance lagged, it couldn't summon the means or power to bring management to account. This breakdown in the rigor of oversight hurt the board, hurt management, and hurt shareholders.

By the end of the 1980s, chief executives who practiced so-called mushroom management—leaving directors in the dark and shoveling them manure for information—were alarmingly common. At some companies, governance became a costly charade. At others, it became worse—an illusion that even the directors believed in.

Today, governance is rapidly improving at the biggest companies, but the improvement has come too slowly in many people's eyes. In a recent survey, nine out of ten of Wall Street's star analysts (87 percent) believe that the board did a good job of representing company *management.* Only one out of ten (8 percent) felt it did a decent job of representing shareholders.[4]

THE RESTRUCTURING OF GOVERNANCE

The spotty corporate record in upgrading a doddering governance institution has spurred change. Chief executives like Kozlowski have fashioned a model that brings out the full potential of the board. This is the model that all corporations should heed, a model that uses accountability, of executives to the board, to boost performance. None of the particulars of the model are uncommon, but they take courage and conviction to implement at the top of the corporate hierarchy.

An Emerging Model

No chief executive has contributed more to the model of governance than David W. Johnson, who took the reins of Campbell Soup in 1990. Johnson grasped right away that in hidebound board governance he had found a buried competitive opportunity. He insisted on revamping governance practices to such a degree that Campbell became a paragon of board practices trumpeted far and wide. Governance reform quickly became the fashion and a powerful means to improve performance.

In a precocious move, the Campbell board published its twenty governance standards in 1992. In the spirit of a search for excellence, it tinkers with the standards continuously. It then republishes them every year in the proxy statement. The board actually scores its own performance on a scale of 1 to 5 in sixteen categories, summarizing the results in the proxy. In 1997, it dinged itself for less-than-perfect handling of performance evaluation, succession planning, and capital spending.[5]

Among other things, Campbell requires a majority of outside directors, bans insiders on the nominating committee, requires stock ownership of 6,000 shares within three years, rejects a poison-pill provision, and requires yearly elections of all directors. In 1997, the board even created a new process to evaluate each director, rating people on independence, accountability, participation, preparation, and even stature. In 1998, it further committed to creating a process for evaluating the performance of each board committee.[6]

Research shows that Johnson recognized earlier than almost anyone else how governance can contribute to performance. A study in 1997 by Paul W. MacAvoy of Yale reported that companies governed by the strict set of principles advocated by the California Public Employees Retirement System give back to shareholders an extra 1.5 to 2 percent in annual returns.[7]

Although the empirical data are mixed,[8] shareholders strongly believe good governance leads to good results. Two-thirds of institutional investors, who together manage $840 billion, say that they would pay an average premium of 16 percent on a stock of a well-governed company, all else being equal.[9] Study coauthor and McKinsey consultant Jennifer H. van Heeckeren writes: "Institutional investors . . . believe strong boards will help companies correct

mistakes, recover from crises, and find, support, and reward outstanding CEOs."[10]

Company boards and leaders like Johnson and Kozlowski have not waited for empirical research to pour in, though. They have acted on their convictions. Kozlowski says that, aside from aiding performance, running an independent, active board is simply the right thing to do. He subscribes to a sort of golden rule of governance: Govern for your shareholders the way you would have them govern for you—if they were the company boss and you were an outsider director or shareholder. "Coming in as CEO, you have the chance to do the right thing," he says. "I did not want to govern an entity I was an autocratic leader of."

At Tyco, one of Kozlowski's first moves was to ask for an evaluation as CEO from the board. He did not want to run without the checks and balances of good governance. The longer a chief executive waits to institute governance reforms, the worse the potential problems, he says. "You can really start believing in your own propaganda," he adds.

So today, with Philip Hampton as lead director, Kozlowski is the only executive on the board, committee heads rotate, Hampton spearheads the CEO and board member evaluations, directors run annually for election in confidential voting, and executives work without management contracts, poison-pill provisions, or golden parachutes to protect them. "We're all here at the will and election of shareholders each year," he says.

Two Essentials

Companies that want to emulate the model created by the leaders will find that recent innovations aim at improving two essentials: director independence and board performance. Both are necessary to enable the board to make unbiased decisions and to stimulate continuous improvement in company performance.

Most companies have started revamping board governance practices by adopting principles that require independence. That means that directors must hail from outside the company and outside the circle of friends and business associates connected with the company and its officers. The principle of independence is easy to place on the board's policy sheet, even though it takes time to implement.

Most of corporate America has gone a long way in improving independence of boards. Institutional Shareholder Services reported in 1997 that 83 percent of the boards of the Standard & Poor's 500 have at least a majority of independent directors. Outside directors sit in more than two-thirds of the board seats. However, boards at smaller firms seem to have missed the message. Institutional Shareholder Services says dominance of insiders at smaller firms is actually growing.[11]

To be sure, even when firms load their boards with outsiders, they may not actually operate independently. That's why many firms have gone further. They nominate new directors solely through the nominating committee and stock that committee solely with outside directors. They also stock all other committees—particularly audit and compensation—solely with outsiders. In addition, the directors stand for election every year. At companies like Tyco and Campbell Soup, they designate a lead director like Philip Hampton to represent the board's contingent of outside directors.

Only about one in five big companies has a lead director today,[12] an idea popularized only recently. By naming a lead director, a board can operate, if needed, unfettered by influence from the CEO. At Tyco, says Hampton, "It did provide the board with a mechanism of independence of organization and a mechanism of convening the board in an orderly way without management."

Lead directors can also set the agenda rather than simply follow it. Hampton convenes a session without management at alternate board meetings, even if he has no particular issue to discuss. In recent years, the directors have talked a lot about the level of Kozlowski's compensation, about recruiting minority directors, about changing the board size, and about the CEO's evaluation. Says Hampton, "We go around and make everyone speak up."

With such independence, boards can bring an extra measure of objectivity to their judgments. Campbell Soup's board went so far in late 1996 to create a selection committee for a new CEO almost entirely independent of chief executive David Johnson. The committee, led by Philip Lippincott, former Scott Paper CEO, met more than two dozen times. It hired Spencer Stuart Associates, the search firm, which recommended seventeen external candidates. In mid-1997, the committee and the board, meeting in part without Johnson, finally selected insider Dale F. Morrison.[13]

The other goal of governance reform, promoting board performance, has drawn just as much attention in recent years. Changes in expectations of performance have actually had more far-reaching impact in some ways because they require directors to spend a lot more time on their board responsibilities.

Search firm Korn/Ferry International in New York found in 1998 that the average director of a big company spent 159 hours on board matters, up 40 percent since 1987.[14] This is one reason that many people believe directors have to strictly limit the number of boards they sit on, often to no more than two. As National Association of Corporate Directors' President John Nash says, "More and more directors know that being a director is a job—and you have to take it seriously."[15]

One of the first changes has been for companies to issue guidelines for the scope of work of directors—two-thirds have done so, according to the Korn/Ferry Study. Campbell Soup, for example, drafted and voted on a list of "Director Requirements" in 1995. The list included an obligation to review succession planning and to critique strategic and operating plans.[16] Such guidelines have made clear that directors have to dedicate renewed effort to the task.

Another of the changes has been a focus on evaluation, a means to constantly upgrade the performance of the board. In three-quarters of companies, the chief executive submits to a regular evaluation, although in less than half of the companies is the review in writing. In one out of five companies, each director submits to a regular performance review.[17] In a handful, the directors even conduct regular reviews of the evaluation process. In any case, the objective is to help the board benefit from the same process of continuous improvement that has become so common in lower levels of the corporate hierarchy.

In the most publicized of governance reforms, companies have reworked director incentives, namely pay and stock awards. They are aiming to encourage directors to think and act like owners. Many companies have required directors to invest a significant chunk of assets in company stock. They have also started paying director fees in stock alone.

During the late 1990s, surprisingly, a broad consensus of the key issues in governance has arisen. The National Association of Corporate Directors—taking the point of view of outside directors—released *Director Professionalism* in late 1996, a document

resulting from a commission led by governance expert Ira Millstein.[18] In September 1997, the association of chief executives known as the Business Roundtable published its less prescriptive Statement on Corporate Governance.[19] In spring 1998, the Council of Institutional Investors, an association of 110 pension funds with over $1 trillion in assets, approved a consolidated list of governance policies.[20] With publication of these documents, the notion that board reform has become a cornerstone of modern management has been cemented in place.[21] These documents detail further the model of governance that has become the standard for industry.

Room for Improvement

For all the improvement to date, many companies have a long way to go in developing the level of accountability through governance that will drive performance. While some companies have readily adopted reforms, others have dragged their heels, unsure that reforms make that much difference.

As examples of the spotty progress, only 44 percent of big firms today have more than five independent directors, only 37 percent convene their boards at least sometimes in the CEO's absence, and only 49 percent rely on an independent committee to nominate new directors. These figures come from a National Association of Corporate Directors survey in 1997 of 1,100 chief executives from 8,100 major U.S. companies. Evidently, a lot of directors, though charged with acting freely in the shareholders' interest, are actually acting with strings still attached to management.

Progress on other reforms is more variable. Only 20 percent of boards evaluate their own performance, and only 53 percent are required to own 1,000 or more shares of stock. However, 70 percent of companies pay directors in cash and stock, and 9 percent pay them in stock alone. In one remarkable development in recent years, 90 percent don't offer any retirement plan at all, widely considered a form of compensation with little to no link to performance.

Companies have made a lot of progress in some areas, little in others. Many chief executives hint at stricter practices in the future. In the National Association of Corporate Directors survey, 84 percent of those chief executives responding felt that boards should have a

majority of independent directors, and 68 percent felt that the nominating, compensation, and audit committees should comprise exclusively independent directors, including the chairmanship.[22]

To the extent that chief executives are hesitant to move ahead with governance reform, they should think again. In a world where every company is looking for the ideas, intelligence, and feedback to solve the riddles of strategy and competitive execution of strategy, an active, engaged board offers one obvious source of help. The model for proceeding has been created by pioneers like Campbell Soup and Tyco International. Executives need look no further than the Campbell Soup proxy itself for a quick overview of leading-edge governance. The proxy is a veritable case study in enlightened board practices.

THE ACCOUNTABILITY GORILLAS

For executives who don't recognize the future opportunity buried in governance reform, a gorilla stands ready to remind them. This is the powerful animal we mentioned in the last chapter: the institutional money manager. Slow-moving companies may well find themselves facing the intense pressure from such managers, in particular those who run pension funds.

The single actor on the institutional stage who has raised the biggest ruckus in calling attention to governance and accountability is Robert Monks, founder of Institutional Shareholder Services and cofounder of the LENS fund, a specialist in shareholder activism. Monks has spent much of his life arguing for greater corporate accountability. His recent merging of LENS in early 1999 with Hermes Pension Management Ltd. spreads his influence to one of the UK's largest pension management groups.[23] Monks's unvarnished view: "The default setting of corporate power is CEO as dictator."

One of Monks's most celebrated causes was the reform of governance at Sears, Roebuck and Co. In 1992, he spoke at the Sears annual meeting, as the company was faltering (before its latest comeback). In the combined chairman and CEO, said Monks, Sears had "a man who marks his own report card . . . [who] has not met his own goal of 15 percent return on equity once in the last ten years (hardly even come close)." Monks called for reform as a way

not only to revive Sears but as a mechanism to juice the value of his considerable Sears holdings. He closed his statement by saying what a lot of shareholders would like to say to a lot of poorly run boards: "Sears has a slogan: 'You can count on us.' We want to hear the board say that to the shareholders. We want to see the board earn that trust."[24]

As a principal of the Hermes Lens funds Monks spends a lot of time at what he calls the "Sisyphean task" of pushing CEOs uphill away from the default position. He believes that companies that don't keep pushing the governance stone uphill risk letting it slide back to the bottom.[25] Monks has shown repeatedly through large shareholdings taken by his fund that when the board starts marking a CEO's report card, performance often goes up.

A classic target of the LENS fund was Stone & Webster, the Boston-based engineering firm. Monks and partner Nell Minow bought a chunk of the firm in summer 1993. At the time, the old-line engineering firm was reporting profits solely as a result of transferring pension surpluses to the bottom line. Otherwise, it was running in the red—a fact difficult for shareholders to discern in the published financial statements.[26]

LENS, a holder of 1.5 percent of Stone & Webster shares, sued over the handling of the pension-surplus accounting, badgered for the replacement of two CEOs and eight directors, pressed for divestment of noncore assets like real estate and an oil and gas division, lobbied for recasting the financial reporting system to separate the pension surplus from operating earnings, and urged management to put the company up for sale.[27] By 1997, as MIT professor Kent Hansen was named lead director of nine outside board members (on the eleven-person board), Monks and LENS could declare victory on their longest-held investment. Not only was governance changed entirely, but company operating profits were up sharply. Between year-end 1996 and 1997, its total return to shareholders soared more than 50 percent, while its heavy-construction industry peer group swooned 25 percent.[28]

Few outsiders evoke the visceral dislike of company bosses that Monks does, but he has helped establish the concept of accountability like no other single person. He also symbolizes the pressure that institutional managers can bring to bear if companies don't voluntarily adopt better governance in the name of accountability. Of

meeting a new CEO he says, "He may not like me, but he knows he can't ignore me." Monks believes that in his years of work, originally brought to special attention from his and Nell Minow's 1991 book, *Power and Accountability*,[29] he has made one point clear: "It's well understood that involvement by owners is a good thing," he says. "It adds value."[30]

Company chiefs may not all agree, but many big institutional managers far bigger than even Hermes Lens certainly do. These powerful managers have a variety of levers for prying the corporate doors open. For Sisyphean backsliders, they have a ready cattle prod. For dictators, they remain prepared with the guillotine. The institutions have amassed unprecedented power, and it grows daily with pension money pouring into their accounts to support the retirement of people from every walk of life.

The Muscle of Pension Funds

Institutional investors come in many forms, as pension funds, life-insurance companies, mutual funds, bank trust departments, and so on. No institution is putting more pressure on companies to govern themselves to better serve shareholders than pension funds.

Pension funds have tipped the balance of power Berle and Means wrote about away from the princes of industry and toward the institutions themselves. Total pension-fund equity holdings alone reached $5.7 trillion in 1997.[31] The California Public Employees' Retirement Systems, or Calpers, now manage over $140 billion. Goliath TIAA-CREF, or the Teachers Insurance and Annuity Association–College Retirement Equities Fund, manage over $135 billion. The managers of these single funds control huge blocks of company stock. They no longer swim with the small investor. They rank as leaders of capital investment. Chief executives simply can't ignore them.

The institutions have gained power through a sequence of permanent changes in capital markets. As they have grown into investing behemoths, they have had to completely change the way they trade stocks. Smaller investors, if unhappy with a company, take the Wall Street Walk. They sell out and go elsewhere. The biggest funds—New York, New Jersey, California, Wisconsin, and Pennsylvania—own so much stock that they can't pull out overnight, or even over a week or a month. If they did, they would

pummel the price of their millions of shares. So they have, for practical purposes, become too big to sell.

If they can't sell stocks to readjust their portfolio's value, their only alternative is to rearrange the management of the companies within the portfolio. Many institutions did not catch on to this change in their fiduciary role until recent years. Now, however, they don't shrink from the task—they don't have to, given their size. In 1997, the institutions held 59.9 percent of all stock of the largest 1,000 companies. That's up sharply from 46.6 in 1987. More remarkable is that in 1997, institutions held more than 70 percent of the stock of 38.9 percent of the 1,000 largest companies. That's more than triple the level (10.7 percent) of 1987.[32]

Although the institutional dollar has become the lifeblood of the public company, corporate executives and boards have reacted reluctantly to the new reality. Just over half of all large companies (55 percent) have an investor-relations program, but only 10 percent of chief executives actively seek the views of institutional shareholders.[33] The failure to reach out shows. Asked their opinion, only one in five Wall Street star analysts feels boards do a good job of representing institutional investors.[34] Commonsense suggests that executives should spend more time with their biggest suppliers of capital, if only to be ready to handle the discontent when their stock prices fail to keep pace with their competitors'.

The Growing Ownership Instinct

Several events in the last decade have turned on the ownership instincts of institutional managers. Remarkably, the possession of mountains of investment dollars would not have been enough, alone, to switch the balance of power between companies and institutions.

First, in the late 1980s, the U.S. Department of Labor ruled that the proxy voting rights that come with stock are valuable assets and that pension managers have the fiduciary duty to vote those proxies if doing so would enhance the value of the pension plan's investment. Eventually codifying this opinion in a 1994 interpretive bulletin, the Department of Labor put trustees of pension funds on notice that they couldn't continue to ignore proxy solicitations. Nor could they vote, knee-jerk style, with management. They had to

think of their pensioners. All of a sudden, trustees had to view themselves as, if not activists, at least involved owners.

Second, executive pay skyrocketed. In 1990, Rand Araskog at ITT took home $11.4 million while ITT stock fell 16 percent.[35] Although Araskog's case amounted to just one data point on a breathtaking, decade-old, skyward trajectory of the value of pay packages, he became the poster boy for outraged activists. What miffed shareholders most was that so many executives pocketed huge sums paid out according to formulas unlinked to performance. The award of seemingly undeserved windfalls of cash and stock put a fire in the belly of activist institutional trustees—a fire that still burns bright today.

Third, in 1992, the SEC changed an obscure rule that had blocked institutional trustees and money managers from freely comparing notes. The rule had required preapproval by the SEC for talking about proxy resolutions with more than ten shareholders, in effect gagging the institutions. Unable to easily pick up the phone just to chat, the institutions couldn't plot coordinated strategy (unless they had plenty of money and lead time). So even a gang of angry institutional gorillas couldn't make an impact. They were caged by an arcane rule.

On October 15, 1992, the SEC lifted the rule. At once, the iron bars of tradition, red tape, and passivity seemed to fall. Less than two weeks later (on October 26), a group of money managers toppled General Motors chief executive Robert Stempel. In January 1993, they deposed three more of Corporate America's most powerful chieftains: IBM's John Akers, American Express's James Robinson, and Westinghouse's Paul Lego.[36] The institutions displayed unprecedented power, and they haven't stopped since, having pressed the boards of one company after another to fire underperforming chief executives.

These three events sent the governance revolution into full swing. Today, the power of institutions is stronger than ever. The biggest players—Calpers, the Wisconsin State Investment Board, TIAA-CREF, and the New York city and state funds—are flexing their muscles like never before. How far their influence will spread is hard to gauge. Governance expert Carolyn Brancato at the Conference Board points out that although pension funds own 47.5 percent of institutional assets, they manage only 19.6 percent. They

farm out the rest to professional asset managers. Rarely do the pros care much about governance, especially if they are short-term momentum investors.[37]

The Tools of the Powerful

Although nobody can say how the play of power will unfold in the years ahead, the activist managers are using a variety of tools to force the hands of executives and boards to govern more accountably. Probably the most widespread, though least visible, is relationship investing. By knocking on doors, requesting meetings, and exercising persuasion behind the scenes, the institutions are coaxing change without making a public show of their efforts. TIAA-CREF, known for applying constant pressure for better board governance in all corporations, worked out agreements with thirty-two of forty-five companies it had approached between 1992 and 1996 with various issues (board diversity, confidential voting), without a proxy resolution ever coming to a vote.[38]

Probably the most visible of tactics to force change are media campaigns that drag the power struggle into the open. Institutions have found that such campaigns, although a blunt tool, strike fear in the hearts of directors. The International Brotherhood of Teamsters, which counsels numerous union funds with $60 billion under management, began publishing its report, *America's Least Valuable Directors* in 1996. In 1997, it listed nineteen, including former diplomat Lawrence Eagleburger. In 1998, it listed nine, including Rand Araskog. The Teamsters mainly targeted directors on low-performing companies with high CEO pay, in Eagleburger's case, Comsat, in Araskog's case, Dow Jones and ITT.[39]

The unions haven't been the only ones in this act. The Council of Institutional Investors published a list of "Director Turkeys" at Thanksgiving time in 1996.[40] It has not ruled out plans to publish another. (The Council includes both public pension funds, like the Pennsylvania State Employees' Retirement System, and corporate funds, like the Coca-Cola Company Retirement Plan.) No corporate director wants to see his or her name on such a list.

A lot more attention has been given by institutions to boards as a whole. In 1995, Calpers graded boards of the 300 largest U.S. companies with an A+ through F, according to their governance

practices.[41] *Business Week* started rating boards on a scale of 0 to 100 in late 1996. Campbell Soup scored highest in both 1996 and 1997—with a rating of 87.1 in 1997—while Walt Disney fell to the bottom at 10.3 because of director conflicts.[42]

It's a good bet that institutions will continue to try new ways to gain attention for their cause. Given that outlandish CEO pay is often a red flag for poor governance, documented in Graef Crystal's 1991 book, *In Search of Excess*, the AFL-CIO decided to go on-line to apply pressure for reform. The union launched www.paywatch.org in early 1997 to track executive pay—and to allow shareholders to voice their disapproval. Surfers at the website can draft a letter or e-mail message to the company's board, a pension- or mutual-fund manager, or Congress. The AFL-CIO has since issued a report detailing cozy relationships between a number of compensation committee members and the chief executives whose pay they set.[43]

Along with the power of publicity, institutions have pressed hard with the power of proxy. They have submitted hundreds of resolutions calling for a majority of independent directors, yearly elections, confidential voting, repeal of poison-pill provisions, minimum stock ownership, independent nominating committees, and a number of other practices that drive board objectivity and performance. The Investor Responsibility Research Center, which tracks shareholder resolutions for 1,800 companies, reports that of the roughly 700 shareholder resolutions in 1998, over 400 concerned corporate governance.[44]

Data from the Investor Responsibility Research Center shows that advocates of better governance are starting to get more than a token vote from shareholders, too. In contests to redeem or require a vote on poison-pill provisions, shareholders won an average 56.7 percent of the vote in 1998. Poison-pill provisions, via various means, protect managers from hostile takeovers. For confidential voting, shareholders won 45.2 percent in 1998. Confidential voting enables all shareholders, even if they have business interests that company management might threaten, to vote as they see fit. Even for a detail that seems pretty picky to most shareholders—an independent nominating committee—shareholders won 19.9 percent.[45]

Calpers, in an example of one successful vote, scored a clear victory at Reebok International in May 1997. The California pension system, which had named Reebok as one of its ten worst performers in February 1997, sponsored a proxy resolution to destagger terms on Reebok's board. Annual elections, Calpers maintained, would improve the independence of boardmembers. In the final vote, 53 percent of shareholders (including Calpers's 599,000-share block) agreed.[46]

Of course, losing in a proxy vote is not like losing everything in a game of poker. The losers often take some chips with them—in the form of publicity for their cause. The publicity, and the threat of a repeat contest the following year, often pushes management to act. The very submission of proxy resolutions, and the prospect of later publicity, also often spurs management to change without even bringing the issue to a vote. Publicity is the major form of pressure in such contests, especially because most resolutions are not binding on management.

When motivated, though, shareholders resort to tougher tactics. The binding resolution has been spurred into use as activists found companies ignoring even those resolutions receiving a majority vote. In 1996, eleven of the fourteen governance resolutions that passed resulted in no company action. In 1997, nineteen of twenty-two resulted in no action.[47] The poor response from the 1996 votes led union activists in 1997 to submit binding resolutions to redeem or require votes on poison pills at three companies: Harrah's Entertainment, Fleming, and May Department Stores. The Fleming resolutions passed, winning 61.9 percent of the vote. The other two failed but received huge votes—51.4 percent at Harrah's (short of Harrah's 75-percent bylaw-prescribed majority needed) and 43 percent at May.[48] The popularity of the binding resolution has continued to grow since.

When the institutions don't use the proxy, they often use their votes to express their displeasure directly. At Walt Disney, even though chief executive Michael Eisner has performed spectacularly, shareholders came to believe that neither he nor the board was accountable to shareholders. Two events galvanized shareholder displeasure: Eisner received a 1996 options package estimated (present value) at $195 million over ten years, and Michael Ovitz received a $96 million severance payment for only fourteen months of work.[49]

Incensed, and bent on protesting such compensation, 12.7 percent of shareholders, led by two dozen institutions, withheld votes on five board members in 1997.[50] In the ensuing year, encouraged by Calpers, Disney itself sponsored a bylaw amendment calling for annual director elections. It won with 60 percent of the vote in 1998. TIAA-CREF, however, was still not happy with the responsiveness of Disney. It sponsored a resolution at the same time urging the company to reconfigure its board of directors and to create more independence. The TIAA-CREF resolution won 35 percent of the vote, more than double the average 16.9 percent for similar resolutions at thirteen companies in 1997.[51]

Particularly aggravating to investors was that thirteen of sixteen directors on the board, by TIAA-CREF's count, are either insiders (including former executives) or have professional or personal ties to Eisner. The head of the compensation committee in 1997, and a member in 1998, is Eisner's personal lawyer (although he recused himself from voting on Eisner's earlier pay package).[52] Investors felt their gullibility stretched too far to believe the board with only three outsiders was accountable to shareholders. Disney responded that TIAA-CREF's definition of "independent" was excessively restrictive (in contrast to Disney's definition, in which a former employee who has not worked for the company in the previous three years is considered independent).[53]

Institutions don't shy from applying even more pressure by taking their cases to court. In late 1997, Carl McCall, New York State Comptroller and sole trustee of the $90 billion New York State and Local Retirement System, filed suit against Columbia/HCA. New York State and Local Retirement System owns 2.7 million shares of Columbia/HCA stock. McCall alleged gross mismanagement, corporate waste, abuse of control, and breaches of fiduciary duty by members of the Columbia board and senior executives of the company. Soon thereafter a number of other institutions, representing 15.3 million Columbia/HCA shares, joined the suit, including Calpers, the State of Louisiana and the City of Philadelphia pension funds.[54]

Calpers alone owns more than 3.7 million shares of Columbia stock, which declined $50 million in value after reports of Medicare fraud were made public in mid-1997. In its announcement of joining the suit, Calpers stressed allegations that fraud was permitted

to flourish because directors failed to ensure that the company had in place adequate information, reporting, and control systems to catch wrongdoing. The message sent by the Columbia/HCA suit, regardless of outcome, is that the board must govern with accountability—or risk far more than embarrassment.[55]

Harbingers of the Future

Although pillorying, proxy fights, and litigation occupy the limelight of the shareholder-activism show, small but significant changes occupy action backstage. These changes show that power continues to slip out of the hands of corporations and into the hands of institutions. Four examples illustrate how the balance of power will never be the same.

In early 1996, TIAA-CREF began regularly screening companies in two dozen governance practices, from board independence and director age to compensation and director diversity. TIAA-CREF has created a data file of 1,650 companies and uses the file to alert its analysts to poorly run boards. Over time, TIAA-CREF expects to correlate its data to corporate performance.[56] The move suggests that one day institutions will be able to screen out stocks based on poor governance practices.

In October 1997, Sarah Teslik, head of the Council of Institutional Investors, submitted a letter to the SEC requesting the SEC amend item 401 of Regulation S-K to replace the paragraph mandating disclosure of director relationships. Through adoption of the new paragraph, the Council wanted the SEC to require even personal friendships—like former college fraternity chums—to be disclosed in proxies.[57] In late 1998, CII amended the letter after talks with SEC staffers, who suggested the demand for disclosure of personal relationships was unworkable. Still, the Council is urging the SEC to require disclosure of relationships involving legal, financial, education, health, medical, therapeutic, cosmetic, and even spiritual services.

Also in October 1997, the AFL-CIO issued proxy-voting guidelines, a book that helps thousands of union pension trustees vote on a range of issues, from board independence to cumulative voting.[58] Veteran activist Bill Patterson also wants to give trustees of the $880 billion[59] in union pension funds standards by which to judge the performance of money managers trustees hire—or, as Patterson

calls them, "captive investment professionals that are less than vigorous in representing plan participant interests."[60] Among Patterson's goals is to get managers to invest in companies that adopt union-friendly workplace practices, like training in high-level skills and payment of high wages.

Finally, in 1998, an advisory group to the Organization for Economic Cooperation and Development (OECD) recommended that the OECD's twenty-nine member countries pursue U.S.-style governance reform.[61] While the OECD countries ponder that prospect, the big gorillas like Calpers aren't waiting. Calpers has already begun pressing its global governance principles, drafted in late 1996, in equity markets in the United Kingdom, France, Germany, and Japan.

Other institutional money managers are following Calpers in pushing for better governance worldwide. In a 1998 international survey by executive recruiter Russell Reynolds Associates, 16 percent of U.S. managers and 53 percent of U.K. managers said they had taken four or more shareholder activism steps in the last year (voting for a shareholder resolution, talking to a company board, sponsoring a shareholder resolution).[62]

The Russell Reynolds survey gives unmistakable proof that enlightened corporate governance has become a cause célèbre for institutional investors. Forty-six percent of fund managers in the United States, 32 percent in the United Kingdom, 43 percent in France, and 71 percent in Australia said they agreed with the statement "Corporate governance is a priority even if high return must be sacrificed." Similarly, 70 percent of fund managers in the United States, 64 percent in the United Kingdom, 84 percent in France, and 89 percent in Australia said they have made decisions not to invest in a company because of poor corporate governance practices.

Rewards of Toeing the Line

Does all this activism make a difference? Certainly it has spurred change in board practices. The face of the corporate board will never be the same. Many people question whether it really boosts company performance, however. Studies are mixed on this subject; some actually show that activism does not help.[63] However, enough research shows positive results that institutions believe strongly

that their fiduciary duty compels them to continue to rattle boardroom cages.

In studies in 1994, 1995, and 1998, Wilshire Associates examined performance at sixty-nine firms targeted by Calpers for corporate activism since 1987. The stock prices of these companies trailed Standard & Poor 500 returns by a total 89 percent (14 percent per year) in the five years before Calpers began badgering them with letters, meetings, and shareholder proposals. Following Calpers action, the firms outperformed average total returns by 23 percent (or 4 percent per year).[64]

Another study, reported in 1995 and updated in 1997, tracked performance at 117 companies that landed on the Council of Institutional Investor's Focus List between 1991 and 1994. These firms presumably became the focus of the Council members' activism programs. Research showed that action among many institutions at the same time had a substantial effect. "In the two years after being listed, firms experienced substantial profitability and share price improvements relative to a variety of control groups," wrote authors Tim Opler and Jonathan Sokobin. "The shareholder value gains are greatest among firms that divested assets and did not announce new acquisitions." Specifically, in the two years after landing on the Council hit list, the targeted firms' stock prices rose a mean of 48 percent compared to 36 percent for the Standard & Poor's 500.[65]

In short, institutions have become convinced that good board governance is a driver of better performance. They are unlikely to back down. What's more, as more institutions take up their fiduciary duties, the pressure will surely increase. The lesson is that good governance has become a core part of achieving full accountability. It is yet one more skill, like quality management, that executives and directors have to learn to be competitive and to meet the pressures of the marketplace for capital.

THE INSUFFICIENCY OF REFORM

The advantage of governance reform is that it restores a process for objective, fact-based decision making at the pinnacle of the company; it restores trust in the workability of the system; and it provides a foundation for running an accountable organization. With

such benefits in the wings, it is little surprise that companies have changed governance practices sharply in recent years. To further gain more of the benefits of accountability, they must continue to do so.

It is also little surprise that companies have recognized they have to respond much more actively to large institutions through relationship investing. They must reach out to institutions, meet with fund managers regularly, and work closely with institutions to meet the needs of an outside constituency without a formal process or antagonistic, public brawls.

Still, the advances in governance and relationship investing fall far short of making companies fully accountable. In fact, the governance story is but one chapter in the larger story of companies striving for full accountability. In the next three chapters, we will explore how companies are attacking the accountability crisis on three more fronts: revamping measurement, management control, and reporting practices. Each of these areas of initiative hold huge promise.

Indeed, for all the success in pushing the new governance agenda, many institutions are starting to realize that they may not see the accountability for the desired turnaround in financial results. They have been addressing a process of decision making but are not addressing the content. They can see that a company may run with all the levers and switches typical of a high-performance vehicle, but in the end they may get less than the best performance from the drivers working those levers.

Of the governance movement, the Conference Board's Brancato says, "Corporations are absorbed with designing and redesigning their governance practices in view of rapidly changing corporate governance norms"—namely, implementing the dozens of modern governance practices.[66] That's a good thing. Taken too far, however, it also worries people. The house of good governance may present an edifice so consoling that it stops companies from pushing for steps that foster additional accountability. That would be the most counterproductive outcome of all, in which companies make a good start renovating the portals of accountability but leave the inner sanctum in disarray.

4

Inventing New Measures

Management by the numbers. Few people would argue the meaning of that phrase or quarrel over its unforgiving overtones. It raises the image of a hard-nosed manager, unbending and implacable, holding people's feet to the fire to deliver the numbers in the profit and loss statement.

But plenty of people might argue over what that phrase *should* mean. These are the people who are breaking new ground as they address the second element of accountability, performance measurement. (See Figure 4-1.) They believe that management by the numbers should evoke a new image. They see an enlightened leader conducting a brave experiment: developing a balanced set of indicators, financial and nonfinancial, to power the performance of the accountable organization.

A few leaders are already conducting that experiment. When Jerry Choate was named chief executive of Allstate in 1994, he faced running the $19 billion business mainly with numbers straight from the financial accounts. They gave a detailed accounting of dollar figures, right down to line items like employee travel. However, they failed to give him a detailed accounting of what he calls "moments of truth," or the most basic drivers of business success.[1]

Figure 4-1
The Second Element of Accountability: Measurement

Moments of truth, the way Choate saw it, came a thousand times a day at Allstate. That's when someone from the company quotes a policy, returns a call for a claim, negotiates with a supplier, or hobnobs with a city official or legislator. These moments of truth are the instants when Allstate builds rapport with the people who sustain it—customers, employees, business partners, community leaders.

The trouble is, when it came to better managing the performance at these moments of truth, Choate found his toolbag empty. Even though Allstate did track corporatewide customer satisfaction and retention, the financial numbers still reigned. Choate began to realize that the financial accounts were too blunt a tool for managing a company during rapid change.

To build accountability for the long term, Allstate and like-minded companies are revamping their measures. In particular, they are supplementing the financial figures with nonfinancial ones. By measuring performance in new ways, they are trying to empower business units, teams, and individuals to more reliably execute the strategy and tactics that drive high performance. They are

also reassuring boards of directors and company outsiders that they have the measures—the factual basis for decision making—to ensure an accountable performance.

It was in a particularly difficult climate that Allstate revamped its measurement system, led by Choate (who retired at the end of 1998) and chief operating officer Edward Liddy. The year was 1994. Allstate faced 46,000 claims from the Northridge earthquake in California. It faced an industry undergoing a revolution, with markets fragmenting into niches, customer expectations soaring, and competitors offering new products through new channels. It also faced the reality that the company's operating practices were slipping behind those of competitors. Company research showed response times as slow.

Under the leadership of Choate and current CEO Liddy, Allstate created a new measurement system that retains the financial rigor shareholders care about and also yields numbers for managing those thousands of moments of truth with customers, employees, agents, and the community. As Allstate sees it, the nonfinancial and financial variables connect in a complex chain of cause and effect. A well-handled moment of truth produces best-of-class processes, and in time, a well-deserved profit.

For example, Allstate measures frontline statistics like claim contact time, the elapsed time between an auto accident and the involved parties' contact with Allstate. In the company's daisy chain of measures, shorter contact time leads to higher customer satisfaction, higher customer satisfaction leads to higher renewal rates, higher renewal rates to higher premium revenues, and higher premiums to higher operating income and share prices. In a parallel chain, shorter contact time also leads to lower legal fees, lower claims payments, lower loss ratios, and, again, to higher operating income and share prices.

It is this chain of linked measures—including many other measures like employee effectiveness and satisfaction, business-process performance, and even employee skills—that drives success at Allstate. Unlike in the past, "we really go to the drivers," says Choate. "By using a balanced framework, you have the ability to ensure long-term success." Today, Liddy continues to use the balanced set of measures as the core of discussions that take place routinely with each business unit.

As they attack the accountability crisis, many companies have traveled the same road as Allstate. They have created a more comprehensive approach to managing with measures. They are finding that, without expanding the universe of variables with which they gauge themselves, they can't deliver peak performance. With the new measures—many unheard of a decade ago—they are bootstrapping their way out of the accountability crisis. They are harboring no sacred cows, either. Even the measures of financial performance, which stand on centuries of tradition, have come under scrutiny.

ON THE FINANCIAL SIDE

Many companies consider the traditional financial measures as tried and true. The financials have stood the test of time. Managers figure the measures may have weaknesses, as we described in Chapter 2, but at least everyone knows what they are and can work around them. More than a few managers disagree, however. They want to find new ways of measuring financial performance to improve decision making. They have tired of the distortions—rapid increases in real-estate market values not reflected on the balance sheet, or huge increases in intellectual capital values expensed as costs for R&D and training. Moreover, they want to seek a solution to the measurement crisis by tinkering with the financials before turning to the less-tested nonfinancials. After all, if the financials are lousy—too narrow, too historical, too functional, too inaccurate—many managers reason that they should fix the broken measurement dial first, before adding new dials.

Many financial managers in the last decade have poured their attention into better measuring "shareholder value," creating measures that are proxies for, or leading indicators of, share-price advances. This focus on shareholder value was kicked off in 1986 by Alfred Rappaport in his book *Creating Shareholder Value,* since revised.[2] The book has been followed up by a number of others, each with its own refinement, but all driving toward the same goal—trying to develop financials that better reflect the variables that push up share prices.[3]

What has triggered the flurry of activity is an age-old discomfort with how poorly accounting numbers relate to share prices. To an astonishing degree, the correlation doesn't exist. Research shows that 90 to 95 percent of the differences in annual or quarterly stock-price changes are unrelated to reported earnings.[4] "In the 1960s and 1970s, about 25 percent of the differences in stock price changes could be attributed to differences in reported earnings," writes New York University's Baruch Lev, who conducted the research. "But by the 1980s and early 1990s, this figure had dropped to less than 10 percent."[5]

Many companies, searching for something better, have been turning to a measure actually developed years ago: economic profit (book profit minus the cost of capital employed). Equivalent to residual income, economic profit remained largely a sleeper for decades, but recent research showed it correlates much better than does net income with stock prices.[6] Such data lit up more than a few faces in the ranks of chief financial officers. They believed they had found, in a figure derived from the accounting books, an indispensable proxy for shareholder value.

Alas, the latest research casts doubt on the superior correlation of economic profit with stock prices.[7] Nonetheless, many finance officers still find the measure appealing because the behavior stimulated by the measure—getting managers to carefully manage the capital entrusted to them—contributes strongly to efficient capital utilization and cash flow, both critical contributors to financial performance.[8]

Indeed, operating without such a measure, managers at many firms strive to achieve profit and revenue goals unrelated to the amount of investors' capital they employ. Although they have to compete with other units inside the firm for capital, once they get their money, managers treat it as if it were a gift. They feel they have incurred no financial cost. No wonder so many general managers try to solve their business problems by investing in a new plant and equipment. Regardless of how much capital they employ, and how well, their budgeted numbers remain unaffected.

They will find that the shine on their numbers dulls quite a bit, however, when they calculate the economic profit figure. The more capital they use, the more they get charged for it. If the charge exceeds book profit, they spill economic red ink. Of course, companies have long used returns measures—return on investment

(ROI), return on equity (ROE), return on capital employed (ROCE), and return on net assets (RONA)—to motivate managers to deliver returns that account for capital usage. The problem is that few managers, at any level, have clearly understood that those returns have to exceed the cost of capital—the weighted average of debt and equity capital, generally 9 to 15 percent—to create shareholder value.

The economic profit figure makes this message explicit. If the economic profit is positive, managers are *building* value for shareholders. If the figure is negative, they are *destroying* value. No more can they pretend that an ROI of, say, 6 percent is a decent figure.

Sadly, for decades, most companies failed at building value, their main obligation to shareholders. In effect, investors gave managers capital to destroy. The managers often boosted earnings but not economic profit. One of their commonest errors has been acquiring companies that returned less than the cost of the capital to buy them.[9]

That's why so many firms have tried economic profit as an alternative measure of financial success. They tell glowing stories of how economic profit has helped them stanch economic losses and produce economic profit. One story comes from Valmont Industries, the Valley, Nebraska, maker of commercial irrigation systems and metal structures. The former top managers had bought a fluorescent-light component business from General Electric in 1987 for $30 million and had tried to rejuvenate it with $10 million more in capital. The business faltered, and Valmont wrote off $11.3 million in 1991 and another $11 million in 1993 to restructure it.[10]

Shareholders, to say the least, were displeased. The company's stock went nowhere as market averages doubled. Directors looked to a new CEO, Mogens Bay, and a new CFO, Terry McClain, to get a leash on managers' use of capital. Speaking of that era, says McClain, "We didn't necessarily think about the amount of capital it was going to take to generate a dollar of business."

Although the irrigation and structures business performed well, managers weren't getting all the right financial cues. "People were growing earnings, but weren't making the best choices about how and where to grow them," says McClain. "Capital decisions were being made on the basis of too much emotion and too little analysis."

In 1994, Valmont, then with sales of $471 million, decided to adopt a simple economic profit measure, dubbed TVI, for total

value impact, calculated by subtracting from NOPAT (net operating profit after tax) a charge for capital employed. They computed this measure for every business unit—and tied people's pay to it right from the start. Managers quickly got the signal that there is a healthy cost to capital. If the cost of capital is 10 percent, say, a return of 9 percent isn't a return of value at all, it's a subtraction.

In the years since making TVI a central measurement and linking bonuses to it, Valmont has kept the focus on capital and gradually watched its fortunes turn completely around. Early on, for example, Valmont's irrigation equipment unit was trying to choose between two capital projects, a new product-development effort or an investment in widening its dealer network. TVI showed clearly what wouldn't have been obvious otherwise—expanding dealers would build far more economic profit.

In the meantime, Valmont executives concluded that Valmont Electric, though nurtured back to profitability by such initiatives as cutting costs, working capital, and warehouse space, could never break the barrier to economic profit. It had to constantly battle pricing pressure in a market where two companies held 40-percent share, while Valmont held only 10 percent. So Valmont divested Valmont Electric in 1997. By guiding all such decision making with the tough discipline enforced by TVI, Valmont reported near-record results in 1997, with a 14.6 percent return on invested capital and sales of $623 million. "Economic profit is like a rudder," says McClain, "keeping people focused in that shareholder direction."

The experience at Valmont shows why many finance managers have become advocates of economic profit: It tells people clearly whether they're adding value, a positive economic profit, or destroying, a negative economic profit. They can't portray positive earnings figures as creating value unless they exceed the capital charge. Economic profit erases the deceit of traditional profit figures. Managers focus on the growth of capital for which shareholders will bid stock prices up.

Other companies have taken more complex approaches to economic profit. Rather than subtracting a capital charge from book earnings, they first adjust the bottom line to better reflect cash flow. Consultants Stern Stewart & Co. have brought the massaging of economic profit to a high art, and even trademarked its concept with the brand name EVA, or economic value added.[11] Stern Stewart advises

companies that, before subtracting the capital charge, they make at least a handful of adjustments to better reflect the economics of the business—like capitalizing R&D and eliminating the amortization of goodwill.

One company that adopted EVA is Harnischfeger Industries, the maker of mining machinery and paper-making equipment. CFO Francis Corby noticed during the recession of the early 1990s that as Harnischfeger's profits sagged, managers were not paying ample attention to capital. The managers watched the top and bottom lines, of course, but ignored the balance sheet.[12]

The view of Corby and chief executive Jeffery Grade was that although the company had to live with the cyclical nature of its business, it didn't have to live with excess capital invested in fixed assets and inventory. Corby also felt the company had to move away from a tradition of allocating capital each year based more on the size of a business than on the returns of each project. The bigger businesses often got the most capital.

"We were falling into the trap of spending a lot of money on capital items that, perhaps, we really didn't need," says Corby. Aggravating the problem was that Harnischfeger had no effective system to track whether the capital projects yielded projected returns. People left it to the finance department to worry about capital. The result was that, while fighting a recession, in 1992 the company ran a $100 million EVA deficit.

Harnischfeger executives wanted to change managers' behavior radically. They knew that they couldn't make progress by badgering them to watch days sales outstanding or inventory turnover. So, in 1993, they started measuring EVA and, by 1994, replaced traditional bonus and profit-sharing plans with an EVA-based incentive pay. It was now up to line managers and salaried employees to manage capital better—their take-home pay depended on it.

The results show just how quickly one measure can alter behavior and, in turn, performance. In the first three years of using EVA, capital employed fell from $1.2 billion to $900 million, an astonishing $300 million drop—while sales increased. Managers and employees across the company began to squeeze excess capital from their operations.

At the company's surface-mining unit, managers told executives like Corby that they couldn't sell equipment with a downpayment.

That just wasn't the way they moved big machines like huge strip-mining shovels. However, once they found their EVA measured, Corby suddenly noticed the "advance payments and progress billings" account come to life. "Operating units found they could in fact get a check with the taking of an order," says Corby. Today, the company even gets advance payments for $8 million pieces of machinery.

Helped by economic recovery, Harnischfeger has now earned positive EVA—returns have exceeded its 12 percent cost of capital—since 1995. Corby reports that managers have come to understand how to manage both the income statement and the balance sheet. "Even though we're a cyclical business," he says, "we have to manage well, on the capital side and on the income side, on the down part of the cycle as well as on the upward part."

With all this help from such new financial measures, many executives believe that a single-minded focus on financials as the overriding performance measure can solve the crisis in financial accountability. They believe that a single measure focuses the company best. People throughout the firm then understand one unambiguous goal. They don't have to try to trade one measure off against another, perhaps failing at achieving targets for both. Some executives believe that fixing the measures of financial performance fixes the performance measure rudder.

ON THE NONFINANCIAL SIDE

Many other executives belong to another school of thought. They believe that one, or even several, financial measures still distort decision making and provide a poor basis for accountability. They argue that the financials, even economic profit, still rely too much on book accounting, provide too narrow a view of performance, and fail as leading indicators of performance. These executives have started experimenting with a measurement mixture, financial and nonfinancial, as the route to an accountable organization.

Surveys show just how common this experimentation is. In one survey, by Renaissance Solutions and *CFO* magazine, 59 percent of companies said they use quality measures to set targets, 57 percent use customer satisfaction, and 30 percent use employee satisfaction.[13] In another survey, in 1998, about 40 percent of U.S. and

Canadian firms said they use product, process, or service quality measures for developing and monitoring strategic plans; about half use customer satisfaction and delivery performance measures; and one-fifth use measures like employee satisfaction, turnover, and training.[14]

To be sure, the idea of operating with a mix of measures isn't new. Since the turn of the century, many French managers have run their firms with a "tableau de bord" (dashboard) of mixed measures.[15] Moreover, most plant managers have long used nonfinancial measures to run their operations. Only since the late 1980s have many top managers tried to pilot the corporate ship with a mix—and insist their facility, business unit, and team managers operate according to a set of measures that complements that mix.

A variety of events have triggered these companies' experimentation. Some have sought to extend the thinking of quality management, in which a culture of "fact-based" decision making requires plenty of quantitative performance data. Some have sought a better way to implement the fine details of strategy, which today include nuances financial measures simply can't capture. Some have simply sought higher performance, which calls for precision targets and feedback only numbers can supply. Their stories differ, but together these companies have opened a window on a new world of possibilities. They show the wide range of measurement that can contribute to solving the crisis in accountability.

A Cue from Quality Management

Analog Devices uncovered the importance of nonfinancial measures from its experience with the world of quality management.[16] Recall from Chapter 2 that at Analog, a pioneer in balanced performance measurement, executives had come to argue over the priority of financial versus nonfinancial measures. The solution was to integrate them, creating one of the earliest sets of balanced measures. (See Table 4-1.) Analog's family of measures was also important to the work of Robert Kaplan and David Norton in creating the concept of the "balanced scorecard," which we discuss in the next section.

The Analog scorecard has three parts: financial, product development, and quality improvement processes. The categories reflect the variables that make or break a firm in the intensely competitive

TABLE 4-1

ANALOG DEVICES SCORECARD: TEN YEARS OF EVOLUTION

1987	1997
FINANCIAL	
Revenue	Bookings
Revenue growth	Revenue
Profit	Gross margin percentage
Return on assets	Selling, management, general, and administrative percentage
	Profit
NEW PRODUCTS	
New product introductions	Six quarter window sales
New product bookings	Six quarter window gross margin percentage
Business plan peak revenue	Number of products to first silicon
Time to market	Customer sample hit rate
	Number of products released
	Tape-outs per product
	New product work in progress
QUALITY IMPROVEMENT PROCESS	
On-time delivery	On-time delivery
Cycle time	Cycle time
Yield	Yield
Defects (parts per million)	Defects (parts per million)
Cost	Quality of work environment
Employee productivity	Customer responsiveness
Turnover	Baldrige score

Source: Robert Stasey, "What We've Learned About Using Scorecards," Analog Devices internal document, 1997, 34.

integrated-circuit business, where customers the world over demand leading-edge designs, delivered to meet their demanding manufacturing schedules. As Table 4-1 shows, Analog has learned to maintain consistency while changing measures to meet new competitive challenges. It has kept the scorecard similar from year to year, and it continues to focus on new products and quality, especially on-time delivery. But it has changed the scorecard gradually over the years to keep up with competitive changes. For example, in 1999, it expects to revise its new-product performance measures.

The scorecard at Analog dovetails with *hoshin* management, a Japanese-inspired form of business planning. Each year, CEO Jerry Fishman kicks off planning by setting one or several of the most important companywide goals, or hoshins. In 1997, one of them, in keeping with company strategy, was to improve new-product generation. Managers down the hierarchy then come back and say how they plan to achieve the specified targets, and what measures they'll use to judge their progress. This process goes back and forth. In the end, the scorecard naturally stresses, among other key performance indicators, the vital issues from the planning process.

Over the years, Analog's trail-blazing scorecard has helped managers deliver huge improvements in several dimensions. Late shipments (of individual invoice line items) plunged from 30 percent to 4 percent after the advent of the scorecard. Outgoing defects spiraled downward from 2,500 parts per million to under twenty-five. New-product development turnaround time shrank by two-thirds. Total factory yield has also improved by several hundred percent over a ten-year period.[17] "If we had not made the progress on improving yield . . . we would have required several more plants" to meet current demand, says Director of Quality Improvement Robert Stasey. Each plant costs in excess of $40 million.

If Analog had not achieved such progress—if it had not adopted new practices for planning, new tools for quality management, and new measures to align the workforce's efforts—it could not have turned in superior financial performance. But the managerial changes turned Analog's fortunes around. Between 1992 and 1997, for example, it delivered total returns to shareholders of 764 percent, compared to 403 percent for the Standard & Poor's technology sector and 247 percent for the Standard & Poor's 500.

Another company that opened the door on a new world of measures is Whirlpool. At Whirlpool, the trigger was the company's acquisition of Philips Electronics' European appliance business in 1989. To bring the company's growing global business together with the same management principles, CEO David Whitwam put together fifteen "one-company challenge teams" to unify management practices. CFO Ralph Hake, corporate controller at the time, led a team around the world, to Europe, Asia, and Latin America, to benchmark companies such as Nestle, Fiat, Hitachi, and Mitsubishi. Although Whirlpool practiced quality management like

Analog, Hake was charged with recommending measurements to propel Whirlpool to world-class performance.[18]

As a follow-up to that work, in 1991, Hake and his team devised a "top sheet" of measures—a "state-of-the-business report," he calls it. Every month, the top sheet lists financial and nonfinancial measures, which has evolved as it continues to guide the company.[19] (See Table 4-2.)

In 1997, Whirlpool executives added a refinement to their measurement approach. They concluded that the top sheet was too com-

TABLE 4-2

WHIRLPOOL TOP SHEET (EXCERPTS)

FINANCIAL
Earnings per share
Cash flow
Economic value added
CUSTOMER SATISFACTION
Market share
Customer satisfaction (by survey)
Brand preference for Whirlpool or Kenmore
Satisfaction with service
Trade-partner satisfaction
Product availability
Telephone answering wait time
TOTAL QUALITY
Worldwide excellence (quality) score
Defect levels
Cycle time
Service incidence rates
PEOPLE COMMITMENT
Leadership survey results
Work-unit survey results
Commitment survey results
Diversity survey results
Percentage completion of high-performance culture milestones
GROWTH AND INNOVATION
Percentage of new product sales

Source: Author interview with Ralph Hake, CFO, Whirlpool, March 1998.

plex for the average employee to grasp. The innovativeness of managers in creating nonfinancial measures had overshadowed the usability of the measures throughout the organization. "We got a Christmas tree and kept hanging ornaments on it," says Hake.

So Whirlpool devised a complementary "balanced scorecard." The scorecard (borrowing terminology from Kaplan and Norton) divides companywide performance measures into three categories: shareholders, customers, and employees. Each category has only three or four of the most critical top-sheet measures. The customer category, for example, includes only market share, trade-partner satisfaction, service incidence rate, and customer satisfaction.

Top executives still use the more comprehensive top sheet for operations reviews and planning, but the scorecard gets all the publicity among employees. Executives believe it more simply communicates corporate strategy—and effectively, too, especially because scorecard targets are the criterion for calculating all salaried employees' bonuses.[20]

A Cue from Strategic Change

Other companies have reexamined their measurement systems during times of corporate transformation. They have similarly turned to a broad range of measures that help their companies achieve a range of new goals.

CIGNA Property & Casualty (introduced in Chapter 2) is one of those companies. At the P&C unit, President Gerry Isom came aboard in 1993 determined to turn a company pursuing a generalist insurer strategy to one pursuing a specialist one. In a generalist strategy, people chase premium revenue wherever they can find it. In a specialist strategy, they chase income only in selected markets with carefully selected customers where underwriters understand the risk and the company can make good margins.[21]

To effect the transformation, Isom and his team devised a balanced scorecard, a classic case of following the method developed by Robert Kaplan and David Norton.[22] (See Table 4-3.) Isom believed the scorecard would give him a tool not only for detailing strategy but also for aligning everyone with the details. Isom desperately wanted alignment of people's minds with the vision and people's work with the strategy at the corporate, division, and busi-

TABLE 4-3

CIGNA PROPERTY & CASUALTY BALANCED SCORECARD

FINANCIAL PERSPECTIVE
Net operating income
Combined ratio
Premium growth by business
Premium mix by business
CUSTOMER PERSPECTIVE
Loss ratio by producer (agent/broker)
Expense ratio by producer
Producer triangle
Premium run-off rate
Performance against producer plans
Average policy size
INTERNAL PERSPECTIVE
Loss ratio
Expense ratio
Price monitors
Underwriting quality survey
Claims frequency
Claims severity
Severity-control monitors
Loss-control utilization
LEARNING AND GROWTH PERSPECTIVE
Premiums per salary dollar
Net operating income per salary dollar
Competency development plan status
Key staff turnover
Key staff acquisition

Source: Adapted from Richard L. Nolan and Donna B. Stoddard, "CIGNA Property and Casualty Reengineering (A)" (Boston: Harvard Business School, Case No. 9-196-059, 1995).

ness-unit levels. If he failed, people working at cross purposes, or for no purpose, would continue to clobber performance.

Of course, CIGNA Property & Casualty already had a rigorous financial system. Managers were used to its signals. For a company making a ninety-degree turn in strategy, however, the financial

figures provided too clumsy a guidance system to ensure success. "Business unit heads in most businesses will spend an awful lot of time on the things they like to do," says Isom. "This [balanced scorecard] causes them to do a much better job of articulating what they should be doing, and then we have a way of measuring against that."

Indeed, the balanced scorecard, along with complementary scorecards in each division and business unit, helped Isom handle subtleties in strategy. Isom wanted every unit to pursue stronger relationships with brokers and agents, for example, but he wanted each one to pursue it differently—by providing more flexible underwriting in one unit, faster underwriting decisions in another, a broader array of services in a third, and more price competitiveness in a fourth. Financial signals alone couldn't begin to define that variability.

The company could have articulated such objectives in terse, narrative statements as it had done before, but using traditional objectives invariably leaves the course of action ambiguous. With the new measures, Isom wagered that managers would get a sharp picture of how strategy should play out in their particular unit.

As an example, one part of CIGNA Property & Casualty's strategy was to build premium growth, but getting profitable growth in different businesses requires different actions—ranging from expanding channels to multiplying segments to broadening product lines. So CIGNA Property & Casualty had to vary the growth measure unit to unit. In some businesses it chose increases in premiums from new producers (brokers and agents); in others, it chose premiums from new segments; and, in still others, new premiums from new-product sets.

The balanced scorecard effort at CIGNA Property & Casualty opened a lot of eyes to the power of new measures. Managers, who formally meet monthly to review scorecards, can now check current results at any time on the company's computer feedback system. Measures hitting target appear in green, those missing target in red, and those on the edge in yellow. The employees have become accountable for success according to an entirely new measurement yardstick. With that new accountability, Isom has turned around the fortunes of the Property & Casualty unit completely, from a $278 million loss in 1993 to a $98 million gain in 1997.

Another company whose story of experimentation with new measures began with strategic change was Mobil Corporation's U.S. Marketing and Refining Division. The change began in 1994. Bob McCool, executive vice president of the $20 billion division, was seeking a means to cement in place a new strategy of targeting and selling to specific market segments. Mobil had grown by marketing a full range of products and services to consumers of all kinds at its fuel and convenience stores, but McCool believed the unit would prosper by appealing to specific market segments.

Mobil's research showed that American gas buyers come in five varieties, which Mobil dubbed road warrior (generally men who drive a lot), true blues (affluent, loyal customers), generation F3 (yuppies on the go who want fuel, want food, and want them fast), homebodies (generally homemakers), and price shoppers. Mobil aimed to focus on the first three, which included 61 percent of all gas buyers.[23] To implement its plan, McCool and his managers decided to upgrade its stations to give fast, friendly service—with, as they said, "speed, smiles, and strokes." They also decided to redesign onsite convenience stores. They wanted to recast impulse-buying convenience stores as destination shops with the right food and snacks for its segments of buyers.

McCool looked for a measurement system to help put the strategy into action and, like Isom at CIGNA Property & Casualty, he adopted the Kaplan and Norton approach. (See Table 4-4.) The measures clarified the strategy in much the same way as at CIGNA, again with the help of each business unit crafting its own scorecard to complement the division one. (Note that in Table 4-4 we have included the objectives as well, showing that the measures don't spring directly from strategy but come from objectives that are fleshed out from strategy.)

One lesson learned at Mobil is that the appropriate new measures may require entirely new data. For example, when it came to delighting customers and getting dealers to build customer loyalty, Mobil managers had no ready source of information. How could they evaluate the quality of the speed, smiles, and strokes? What they came up with was a "mystery-shopper" program. An independent company, buying gas and snacks at each station each month, graded each station according to twenty-three categories,

TABLE 4-4

MOBIL CORPORATION, U.S. MARKETING AND REFINING, BALANCED SCORECARD

OBJECTIVE	MEASURE
FINANCIAL PERSPECTIVE	
Return on capital employed	Return on capital employed
Cash flow	Cash flow excluding dividends Cash flow including dividends
Profitability	Profit and loss ($ millions after tax) Net margin (cents/gallon before tax)
Lowest cost	Total operating expenses (cents/gallon)
Most profitable growth targets	Volume growth, gas retail sales Volume growth, distillate to trade Volume growth, lubes
CUSTOMER PERSPECTIVE	
Continually delight the targeted consumer	Share of segment Percentage of road warriors Percentage of true blues Percentage of generation F3's Mystery-shopper rating
Improve the profitability of our partners	Total gross profit, split
INTERNAL PERSPECTIVE	
Improve environmental, health, and safety performance	Safety incidents Environmental incidents
Product, service, and alternate profit center development	Alternate profit center gross margin/store/month
Lower costs of manufacturing versus competition	Refinery return on capital employed Refinery expense
Improve hardware performance	Refinery reliability index Refinery yield index
Improve environmental, health, and safety performance	Refinery safety index
Reduce laid down cost	Laid down cost vs. best competing supply—gas Laid down cost vs. best competing supply—distillates
Inventory management	Inventory level Product availability index
Quality	Quality index
LEARNING AND GROWTH	
Organization involvement	Climate survey index
Core competencies and skills	Strategic competency availability
Access to strategic information	Strategic systems availability

Source: Robert S. Kaplan, "Mobil USM&R (A): Linking the Balanced Scorecard" (Boston: Harvard Business School, Case No. 9-197-025, 1996). Copyright © 1996 by the President and Fellows of Harvard College. Reprinted by permission.

like station appearance and rest rooms. The mystery-shopper rating became a key measure on the scorecard.

Even frontline workers became acutely aware of the new measures, as their pay was tied to performance two years after the introduction of the division scorecard. Employees became eligible for bonuses of up to 30 percent of salary, paid once each year. The bonus amount is based on corporate, division, and business-unit performance, as gauged by the scorecard. Mobil executives are convinced that the link to compensation both improved employee focus and boosted results.[24]

Indeed, with everyone focused on the scorecard, the division's performance soared. In less than four years, the operation went from losing half a billion dollars in cash flow (in 1990) to gaining half a billion. The balanced scorecard focused the units' initiatives and kept them aligned with strategic objectives.[25] By year-end 1997, the division's ROCE had leaped to 12 percent, from 6 percent in 1993.

A Cue from Performance Improvement

The story of invention of new measures at other companies has come simply from an effort to improve performance. These companies show still more the variety of measures.

The story of the Bank of Montreal, the third-largest bank in Canada, begins in 1989. Matthew Barrett had just taken over as chief executive. Although Barrett wanted a tool for a variety of purposes, one of the major ones was to better measure and reverse lagging performance. Bank productivity at the time was dismal. Costs as a percentage of revenues were the highest of all large Canadian and North American banks. (Bank of Montreal also owns Chicago's Harris Bank.) Returns to shareholders were not much better—five-year returns on common shareholders' investment were just 4.4 percent in 1990. As CFO Robert Wells says, "By a number of measures of financial performance, we were in poor shape."[26]

Barrett and his new executive team didn't look to the financial accounts and focus on short-term slashing of costs. Instead, the executives of the $210 billion bank wanted the employees themselves to turbocharge the performance of the bank at every level. The measurement system was the tool to do it. As CFO Wells says, "It's better to manage through communicating what is expected and

monitoring results as opposed to a more authoritarian or dictatorial management approach where you tell people what to do and control it."

In a decided difference from Analog, Whirlpool, CIGNA Property & Casualty, and Mobil, the Bank of Montreal articulates strategy and, in turn, creates its scorecard by creating goals and objectives for each of its key stakeholders: shareholders, customers, employees, and communities. In each category, it specifies results measures and drivers. (See Table 4-5.)

The system then became the lever for Barrett to delegate authority and clarify expectations at every level of the company. For example, he set a goal to improve productivity by 2 percent each year. With the measurement system, he could cascade that goal down through the bank to every one of 1,100 Canadian retail bank branches. Each of those branches got its own productivity-improvement target.

In implementing the measures, each branch measured its performance partly with a subset of bankwide measures. One example is the number of accounts per customer, a key indicator of profitability (the more accounts per customer, the more profitable the customer, because the bank can spread relatively fixed service costs over more accounts). However, each branch also devised its own measures, tailored to its own market, to guide it in meeting the target. One branch might focus on boosting the number of new mortgages, while another might focus on cutting administrative costs. By drawing on the corporate scorecard for guidance and by tailoring measures to each unit, Bank of Montreal created unprecedented accountability throughout the organization.

A Cue from Intangible Value

One company that walked a unique path in developing new performance measures is Skandia Group, the $8 billion Swedish financial-services firm. In the 1980s, then-CEO Björn Wolrath and First Executive Vice President Jan Carendi had become dissatisfied with the signals from the traditional accounting system. They felt the strengths of a service business, especially a knowledge-intensive one, lay in people's talent, in relationships, and in Skandia's ability to manage competence. Wolrath and Carendi knew they couldn't build value by managing bricks, mortar, equipment, and inventory.

TABLE 4-5

BANK OF MONTREAL'S PRIMARY AND SELECTED SECONDARY MEASURES

SHAREHOLDERS

Primary measure
- Return on common shareholders' investment

Secondary measures
- Revenue growth
- Expense Growth
- Productivity
- Capital ratios
- Liquidity ratios
- Asset quality ratios

CUSTOMERS

Primary measure
- Customer satisfaction and quality of service

Secondary measure
- Customer surveys for different market and product requests

EMPLOYEES

Primary measures
- Employee commitment
- Employee competence
- Employee productivity

Secondary measures
- Different elements of employee opinion survey
- Different elements of customer service index (regarding employee competence)
- Financial ratios of employee costs to revenues by different classifications

COMMUNITY

Primary measure
- Public image

Secondary measure
- Different external surveys

Source: Anthony A. Atkinson, John H. Waterhouse, and Robert B. Wells, "A Stakeholder Approach to Strategic Performance Measurement," *Sloan Management Review* 38, no. 3 (1997): 25(13).

They could build value only by getting a grip on the value of intangibles and figuring out how to develop them.[27]

In 1991, Carendi made a leap of faith—that launching a program to understand and build so-called intellectual capital would propel the company's future success. He reasoned that Skandia needed to make intellectual capital a function, just like finance or marketing. He did so, and named Leif Edvinsson director of intellectual capital, the first such position in the world.

Early on, Edvinsson and his team began their work by inventorying hidden value at Skandia; that is, the value that failed to appear in the financial statements. Many Swedish companies were valued on the Stockholm Stock Exchange for three to eight times their book value.[28] (For comparison, the average in the United States in mid-1998 was five times book value, which means the balance sheet reflects only about 20 percent of the value of the company.) Edvinsson's job was to create a way to visualize the hidden sources that made up the difference. The team inventoried a number of items, like trademarks, concessions, customer databases, and alliances. As they worked, they developed a theory: Intellectual capital comes in two varieties—human (people) and structural (systems, procedures, information technology, and alliances).[29] The first walks out the door every night; the second does not.

As they refined their understanding of the sources of value, a critical question came up. Would Skandia use its emerging model for valuation or management—that is, for putting a number on intellectual capital assets or for developing a way to better manage an intellectual capital-intensive business? The answer is that it would do both.

To create a management tool, Edvinsson and his team devised the Skandia Navigator, a balanced measurement system that Skandia created in the same era as the balanced scorecard. The Navigator shows the remarkable variety of measurements companies are developing today. (See Table 4-6.) In the last five years, Skandia has developed and refined Navigators following its unique five-part format. The company has even created PC-based software to enable people to dissect each part of the Navigator, as well as simulate the results of their actions. Table 4-6 shows the Navigator for Skandia's European telemarketing insurance company, Dial.

TABLE 4-6

SKANDIA GROUP'S NAVIGATOR (NAVIGATOR FOR DIAL)

FINANCIAL FOCUS
Gross premiums written
Gross premiums written per employee
CUSTOMER FOCUS
Telephone accessibility
Number of individual policies
Customer satisfaction
HUMAN FOCUS
Average age
Number of employees
Time in training (days/year)
PROCESS FOCUS
Information technology employees/total number of employees
RENEWAL AND DEVELOPMENT FOCUS
Increase in gross premiums written
Share of direct payments in claims assessment system
Number of ideas filed with Idea Group

Source: Skandia Group, "Customer Value: Supplement to Skandia's 1996 Annual Report" (Stockholm: Skandia Group, 1996).

Today, Edvinsson points out how the Navigator reflects the original concern of Wolrath and Carendi. "The renewal and development focus and the customer focus are the key drivers for your future earnings capability," he says.[30] He explains that the measures highlight a fact of business today: Companies must continually learn and adapt to new market situations. The financials alone don't much help a company adapt, but the broad mix of measures provides the needed "three-dimensional" balance, balance between performance of the future and the past, balance between internal and external, and balance between financial and nonfinancial. We discuss Skandia more in Chapter 9.

SOME TEMPLATES EMERGE

As the experience of Valmont, Harnischfeger, Analog Devices, Whirlpool, CIGNA Property & Casualty, Mobil, Skandia, and Bank of Montreal shows, companies have experimented broadly with new performance measures. Their experience also shows how companies have chosen a variety of measurement templates to get critical issues in the open. The balanced scorecard, as at CIGNA, and stakeholder scorecard, as at Bank of Montreal, are two templates. Other companies organize their thinking around the value chain, developing measures to achieve excellence in product design, manufacturing, distribution, marketing, and other company core competencies and processes.[31] These templates force executives to take a comprehensive view of the enterprise and help ensure they ask all the right questions. Chapter 7 shows that all of these concepts converge as one, and in that chapter we recommend a composite template for the accountable organization.

Whatever the final means to organize measurement, the corporate-level template sets the organization up for brainstorming complementary sets of measures down through the organization. Although we show top-level measures only, managers must cascade measures down through the hierarchy, each tier of management following the rough template of the one above. By taking a cue from the family of measures developed by corporate executives, every unit of the organization attacks the crisis in accountability in a coordinated way. Business units, functional groups, facilities, teams, and even individuals obtain guidance from measures that dovetail with corporate strategy. When peoples' efforts to execute strategy are aligned in this way, a company can expect to join leading firms in enjoying the benefits of increased accountability.

A prime challenge is creating what authors and consultants Geary Rummler and Alan Brache call a "performance logic" among all measures.[32] From the bottom of the organization up, managers must ask, How does each variable measured contribute to some higher-level variable and, in turn, contribute to organizational results? From the top down, What variables drive the economic profit figure and, in turn, what variables drive those variables? The critical step, according to Rummler and Brache, is to configure the

wires behind the dashboard so that measures at the corporate, process, function, and team levels connect.

A Deloitte & Touche survey showed company efforts to revamp and broaden measures have met with widespread favor. Although most businesses are dissatisfied with their measures, the study revealed, the level of satisfaction increases at firms using a variety of nonfinancial measures. It also increases as firms use capital-usage measures like economic value added.[33]

Taco Bell is a classic example of a firm discovering the value of nonfinancial measures. The fast-food giant tracks profits daily by unit, market manager, zone, and country. Those profits link tightly to both employee and customer satisfaction. How did Taco Bell discover the linkage? As for customer satisfaction, exit interviews with 800,000 customers showed that stores ranking in the top quartile in pleasing customers also ranked at the top in all other measures, including financial. As for employee satisfaction, it found that 20 percent of stores with the lowest employee turnover rate yielded double the sales and 55 percent higher profits than the 20 percent of stores with the higher rates.[34]

In an example of discovering the value of measures of a far different kind, advertising giant Young & Rubicam has argued for measures of brand value, maintaining that "stronger brands lead to high growth, higher earnings, and higher stock price." Young & Rubicam's Brand Asset Valuator measures leading and lagging indicators, including differentiation, relevance, esteem, and knowledge. That these indicators are useful for both internal and external evaluation of corporate performance is supported by a recent study. Researchers showed that "brand value estimates capture information that is relevant to investors and are sufficiently reliable to be reflected in share prices and returns."[35]

Despite the value of these new gauges of performance, some executives will doubt that managers or workers in an organization can handle multiple measures. They will fret about the risk of too many measures confusing people, about people making improper tradeoffs, and about managers suboptimizing their groups' performance. These are real risks, but many managers believe that their organizations have no choice but to fight back the growing complexity of business challenges with a richer set of measures.

In the transformation of Tenneco, chief executive Dana Mead outlined thirteen categories of excellence for which all firm managers were to be accountable. He called these the "baker's dozen": operating-cost leadership, customer satisfaction, profitability, market position, customer base, productivity, capital effectiveness, health and safety, environmental quality, management capital, product development, information systems, and international business. Asked what's most important, Mead is fond of telling managers, "There are no priorities among essentials."[36]

Many executives would agree with Mead. Even many executives who spend more time worrying about analysts on Wall Street than anyone else feel that the financials are just not enough. They recognize that the nonfinancial measures are often the drivers of financial performance. Today's competitive demands require managers to, in effect, keep a half dozen pie plates spinning at once. They can't get away with spinning just the plate filled with financial data.

Of course, spinning the measurement plates like a virtuoso still won't create the accountable organization. The accountable performance requires creating a winning strategy and executing it by adopting all four elements of accountability. In the next two chapters, we discuss the remaining two elements: more tightly integrated management systems and broader internal and external reporting. Weaving the four elements together is the secret to vanquishing the crisis that so many firms face today.

5

Managing the System

When Earnest Deavenport, chairman and CEO of Eastman Chemical Company, went on a road trip to sell the virtues of his company to Wall Street in 1993, analysts didn't much care about the company's most remarkable achievement: winning the Malcolm Baldrige National Quality Award just months earlier—the first chemical company to gain that honor. "I would say that over 80 percent of the analysts I talked to had never heard of the award," Deavenport recalls.[1]

What an irony. An award like the Baldrige shows that a company like Eastman, the $5 billion Kingsport, Tennessee, spin-off from Eastman Kodak, has been installing the kinds of management and control systems that make people at every level accountable for performance, financial and nonfinancial. These systems, albeit no guarantee of future success, convert strategic planning into front-line action. Many companies today that are trying to achieve greater accountability are retooling these internal systems, trying to install just the kind of discipline that Eastman long ago established.

In Chapter 3, we found that companies aiming to build an accountable organization have been experimenting with new board governance practices. In Chapter 4, we found they have been experimenting with new kinds of measures. In this chapter, we find

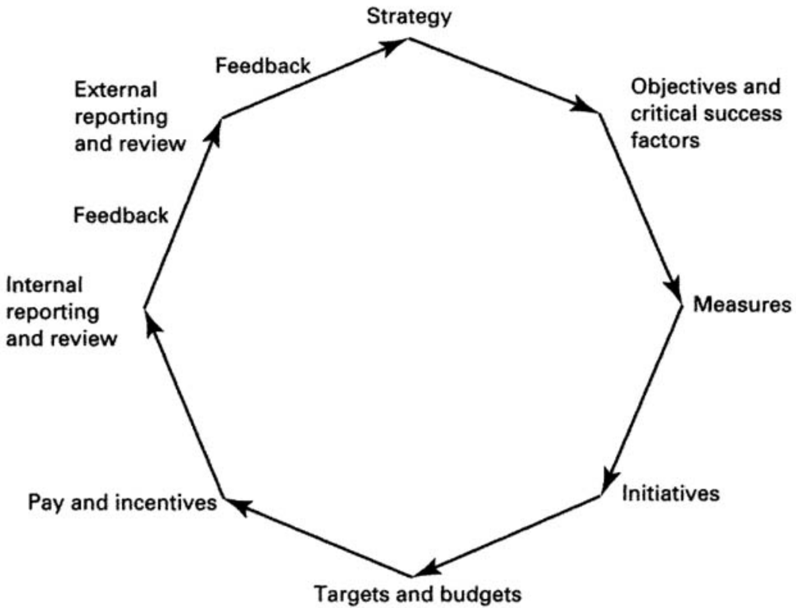
Figure 5-1
The Third Element of Accountability: Management Systems

that they are also addressing the third element of accountability, management planning and control systems. (See Figure 5-1.) They are reexamining and renovating internal planning, budgeting, review, performance measurement, and pay structures.

To deliver the growth in earnings that analysts want—indeed to deliver growth in value of any kind—a company must have a system that ensures that signals given at the head of the company flow to each extremity, and back again. Akin to a corporate nervous system, the management planning and control system enables the accountable organization to flex its performance muscles—and deliver premium value.

Note that companies adopting new planning and control regimens are not always inventing new systems. They are often taking a second look at the systems they already have for formulating and executing strategy. Figure 5-2 shows a skeletal view of the succession of steps in management control and planning. The loop demonstrates that managers working on their management planning and control systems to further accountability are plowing familiar—if rocky—ground.

Figure 5-2
The Elements of Planning and Control



From the start, some managers will object to the notion of emphasizing control systems as a part of accountability. "Control" rings a dissonant bell. Managers might argue that such systems drive the creativity and zeal from the hallowed land of innovation. In fact, the reverse appears to be true. In over ten years of research, Harvard's Robert Simons found that "the most innovative companies used their profit planning and control systems more intensively than did their less innovative counterparts."

Simons suggests an explanation for this paradox: Control systems help managers balance the tension between the yin and yang of management—between restraint and freedom, empowerment and accountability, top-down direction and bottom-up creativity, and experimentation and efficiency.[2] The control sought by leaders of accountable organizations is not the command-and-control of the sweatshop. It is the interactive sensing and responding that guides strategy and makes sure everyone in the organization stays on track to deliver it.[3]

MENDING THE SYNAPSES

Many executives complain that the strategic plan they craft with pain and anxiety ends up in the same place every year—on the shelf. They dust it off the next year and perform the strategic-planning drill once more. Companies that practice this annual ritual in such an ineffective manner should take the hint that their management systems for accountability have broken down. If the strategy gets so little attention at the top, odds are that it gets no attention at the middle level and with frontline managers.

This broken synapse at the top of a planning and control system probably mirrors broken synapses elsewhere. The annual plan and objectives are probably not considered in the budget. The budget runs at cross purposes with improvement initiatives. The initiatives match poorly with people's performance plans. The performance plans get little support from pay plans. The result is an unpredictable or confused response from employees to the strategic objectives of management. Full accountability is impossible.

As Arthur Andersen consultant Steven Hronec says, most employees don't know how what they're doing ties to anything else in the organization. "Just go out there and slay dragons for God and country" is the message they get from their bosses, says Hronec. "That's not effective in motivating a workforce in the long term."[4]

Most managers know this already, but leaders of accountable organizations are finding they can operate in a better way. By merging control practices and systems into an interconnected whole, the company can gain the full power of accountability. An integrated system triggers quick reflexes of corporate action, ensures clear planning, precise execution, thorough follow-through, reliable feedback, and even greater worker motivation.[5]

Recall Mobil's U.S. Marketing & Refining Division from Chapter 4. Each tier of management creates a scorecard that dovetails with the scorecards above in the hierarchy. The scorecards connect like links in a chain from the division level all the way to the frontlines. All employees' scorecards link to their supervisors, and to compensation. This helps employees, from truck drivers on up, to understand how they contribute to corporate strategy: specific, measurable objectives and performance plans make the connection clear.

One caveat about management and control systems: Managers and employees can blunt their effectiveness through gaming and dysfunctional behavior. Division employees may push up quarterly revenues by shipping high-value products early—which can hurt customer satisfaction by annoying people buying low-value products. Or engineers may rush products to market to meet cycle-time goals—which can push up long-term warranty and service costs. One division or function may do well at the expense of another. Unfortunately, no company can escape such hazards entirely. Managers must simply take care to design all elements of the management planning and control system to focus employees on achieving the overall corporate strategy—and not achieve just personal or divisional gain.

To ensure that a management planning and control system works, executives must educate employees on the new, accountable approach the company is taking. They must communicate both the goals of the system and the goals of the company. Their objective is to obtain extensive acceptance and participation by employees in making the new system work. Every employee must understand the logic and flow of Figure 5-2, the managerial logic for keeping employees aligned with corporate objectives.

The Eastman Chemical System

An excellent example of a company integrating management planning and control systems is Eastman Chemical, the twelfth largest chemical maker in the United States. The genesis of Eastman's approach dates to the early 1980s, when the company adopted the quality management process at every level of the organization. Unlike so many other companies, Eastman did not quarantine quality fever in the factory; rather, it exposed executives to a full dose.

Today, everyone in the company uses the same plan-do-check-act quality-improvement cycle—including Deavenport's executive team. The only difference for executives is that they subject conceptual processes to the quality procedure, rather than physical chemical production. The executive team then coaches every team that reports to them to hook together their quality management and control processes.

Executives' prime process is "strategic quality planning." The "plan" stage of that process directs executives to create the mission and vision, develop strategic alternatives, select key result measures, and determine companywide improvement focuses like cycle-time reduction. The "do" stage directs them to implement improvement projects. The "check" and "act" stages direct them to conduct regular progress reviews, give rewards, take corrective actions, and document lessons learned.[6]

Once executives have started strategic planning at Eastman, they hand the planning and control job down the chain of command. "Interlocking" Eastman teams then create complementary action plans and interlocking measures; that is, the executive team develops the top measures to gauge strategic success. Each member of the executive team then leads his or her own team in developing his or her own plans and the unit's measures. Each member of that executive's team runs another team, creating another set of measures, and so on down to the frontline. Every team and measure interlocks with the ones above. The goals and measures vary only to remain relevant to each level.[7]

Because of the company's focus on quality, executives chose a stakeholder approach to come up with key result measures. Deavenport explains that, when the executive team came to the point of defining its customers—the people who receive the output of their efforts—the team decided it had five: customers, employees, investors, suppliers, and publics (communities, government agencies). This decision helped clarify the executives' mission: to create superior value for all stakeholders.

For example, one top-level measure is customer value—that is, the value Eastman delivers to customers as measured by surveys. Other measures are employee retention; community satisfaction—how happy plant neighbors are with Eastman's control of pollution and odors; and, the key financial measure, economic profit.

Step into any room at Eastman and you're likely to see the central role the broad mix of measures plays in management. On the one hand, in the control room of a plant, a bulletin board displays a set of hand-drafted quality-control charts. On the other hand, in the executive conference room, wall panels slide back to reveal a raft of corporate-level graphs: Two of the graphs trace safety. Six show a running total of top executives' visits to customers. Four show

progress in innovation, from identifying new product needs to new products as a percentage of sales. A network of a dozen more show, in a cause-effect tree, the many key measures that contribute to return on capital (customer satisfaction, sales revenue, labor costs, inventory, and so on).

All of these measures feed and inform Eastman's management planning and control systems. As part of the system, Eastman's executive team singles out several major improvement programs each year. In 1997, they tapped global growth, reducing process cycle time, and a cost-control program called "resource effectiveness." Top managers measure the progress of each of these programs, and every quarter the company posts placards on bulletin boards in every facility showing progress measured.

Eastman includes in its planning and control system a job-development and review process for each employee. Following a similar plan-do-check-act cycle, an employee and his or her "coach" agree on job expectations, the employee later assesses the gaps in his or her performance, and the coach and employee draft an improvement plan. Coaches and employees formally review not only how the plan ties to personal growth but how it ties to the major initiatives that support the company's strategy.

Eastman reinforces the tie to company strategy through the last leg of its management planning and control system, its pay plan. In the early 1990s, Eastman executives decided to no longer base variable pay on different measures for different people in different parts of the company. To gain the broadest possible alignment of effort, they sought instead one measure, and chose economic profit. Every Eastman employee puts 5 percent of his or her base pay at risk every year. If the company doesn't earn the cost of capital, nobody gets a bonus. If they do better, they get up to 30 percent.

Eastman shows how one company has put together, in tight succession, all the links of the chain of management planning and control. The logic is compelling, though certainly not new. Many managers, however, never carry through on it. Their systems let people drop the ball between strategy and budgeting, between devising new measures and using them, or between creating business-unit action plans and connecting them to people's reviews and pay. They need to create systems that help them pick up the ball and keep it moving—toward a winning game.

The Tenneco System

Another company that has installed a tightly linked management planning and control system is Tenneco Inc. Tenneco installed its systems under very different circumstances, as part of a wrenching three-year turnaround campaign. It worked with Val Feigenbaum of General Systems Corp. to build what it calls its MPC (management planning and control). In outline, Tenneco's system mirrors Eastman's, including many interconnected steps that ensure accountability and drive performance, but Tenneco has customized many details.[8]

The Tenneco system begins with long-term strategic planning to lay out the big picture for the company. It then moves to long-term business planning and annual operating planning to lay out a working plan for each business unit. It fleshes out those plans by specifying objectives, measures, and people responsible in a document called a matrix. Finally, it links *every employee to the matrix* with individual, annual performance agreements. The MPC essentially takes the grand scheme for company strategy and explodes it into concrete, bite-size pieces—each with someone's name on it.

As Richard Wambold, the executive who guided its development, says: "It was all about how you make a commitment and live up to it." As at other companies, Tenneco's goal was first to develop a strategy and then to foster a commitment and structure for driving it through the entire organization.

Three elements in particular ensure that commitment at Tenneco, says Chief Executive Dana Mead. The first is the MPC matrix, which lists objectives, people responsible for meeting them, measures, and performance targets. The matrix, in principle, differs little from the balanced measurement schemes described in the last chapter. The second is the so-called performance agreement, a written understanding of objectives, action plans, and performance measures signed by each employee. The third is a compensation plan that ties pay to performance. More than any of the other features of the management planning and control system, says Mead, these three form the basis for accountability.

"We're trying to emphasize that you are accountable for these goals," says Mead. "All of this created much more management intensity."

The matrix, like a balanced scorecard, quickly became a high-profile guide to action, because, after executives created the first

matrix, business-unit and functional chiefs created their own, in the same way as described for companies in the last chapter. The matrixes cascaded downward, each one specifying increasingly refined objectives, measures, and targets, until someone's name became assigned to individual tasks. The cascading ensured that activities at the bottom contributed directly—"in a straight line," as Wambold says—to higher-level goals.

Tenneco followed up with disciplined procedures for reporting results. For executives, Chief Executive Mead holds joint quarterly reviews. The heads of Tenneco's business units (formerly six, now two) meet and actually present their matrixes and results to each other. Such open reporting, in any organization, immediately creates more commitment to delivering results.

CFO Robert Blakely says that the first few meetings back in 1992 marked a sharp cultural change for Tenneco. "As one group, one management team, you'd have to explain what's going right and what's not going right," he says. "Obviously, that raises the bar, raises the intensity . . . creates a lot of peer pressure."

The performance agreement makes that accountability explicit. Everyone in the company has one—even the top executives. In each year's fourth quarter, everyone works with his or her boss to draw up what amounts to a contract of objectives, actions, and measures for the coming year. Blakely, for example, asks those working for him to provide their lists of priorities for the next year. He also asks the board of directors for its priorities for finance. He then prepares a summary memo outlining what items should be in his agreement when he and Mead prepare it. The agreement has both financial targets (working capital, for instance) and nonfinancial (reengineering the cash-forecasting process).

The compensation system cements a sense of accountability firmly in place. The company pays the average executive 50 percent in salary, 50 percent in compensation that varies with performance. It pays top executives only 30 percent in salaried pay, 70 percent variable, based on explicit goals. The executives get rated not just on financial goals but on items like safety, quality, equal employment opportunity, diversity, and leadership. "We dock 'em," says Mead, if executives fall short.

Since the early hard days of turnaround management, Tenneco's system has reversed the company's fortunes. By 1996, the company

could report operating margins, return on capital employed, and sales growth at least 20 percent greater than its industry peers in packaging and automotive parts (the two businesses not spun off in its five-year-long restructuring).[9] As evidence of what the company considers key to accountability, it still insists that all acquired firms install its measurement matrix, performance agreements, and pay practices—as well as separate management reviews for quality; strategy; executives; and environment, health, and safety.

Eastman and Tenneco are hardly the only companies that have merged accountability with disciplined planning, budgeting, and reward systems. Companies like Allstate, CIGNA Property & Casualty, Mobil, Whirlpool, and Analog Devices have, too. Although each has customized the system to meet its needs, all report far greater clarity and alignment in executing strategy. They also report rich feedback for organizational learning and continuous improvement. These are the companies that have tackled one of the tougher managerial challenges of the accountable organization.

THE CULTURE OF ACCOUNTABILITY

As managers are building these new systems, they are showing that, to be effective, the accountable organization has to use them appropriately. By appropriate, we mean using them according to a philosophy that is a far cry from that perfected by such financially driven firms as ITT in the 1960s and 1970s. In that era, top executives handed down financial budgets to division chiefs, who in turn handed them down to business units. The finance department ran a control system that measured results and variances—and woe to the manager that couldn't explain and eliminate those variances.

The purpose of that system was to exact accountability. At its best, it did so—but of a very narrow kind, usually for short-term financial results. Managers were creating a culture of compliance to the iron hand of the financial budget. They were cultivating bad-cop accountability.

With the building of management planning and control systems today, accountable managers are trying to *elicit* accountability—and of a much broader kind, too. They want people to help drive the long-term performance of the organization. They are reversing

the modus operandi of the past by creating a culture of commitment—commitment to delivering ever-improving value as measured by a host of variables.

What differentiates the new culture from the old one?

- Accountable managers are encouraging not just continuous judgment but continuous improvement. At Mobil's U.S. Marketing & Refining Division, Executive Vice President Bob McCool remarked in 1996 at how, having adopted the balanced scorecard, he had changed entirely the way he ran business meetings: "In the past we were a bunch of controllers sitting around talking about variances," he said. "Now we discuss what's gone right, what's gone wrong . . . what resources do we need to get back on track, not explaining a negative variance due to some volume mix."[10]
- Accountable managers are insisting that everyone, no matter how low in the organization, participate in decision making. At Allstate, Assistant Vice President Loren Hall led a team of ten people to devise new business performance measures. They involved employees, agents, and frontline managers to get ideas on how to tune the system.[11]
- Accountable managers are setting an example of constant learning, and not just about others but about themselves. At Eastman Chemical, executives ask subordinates during 360-degree performance appraisals (by superiors, subordinates, peers, and even customers) questions like: "What is it I do that you feel is especially well done? What am I doing that you wish I would quit doing? What would you like me to do more of? If you had one single piece of advice you could give me to improve my effectiveness, what would it be?"[12]
- Accountable managers are insisting on building learning organizations.[13] They are going beyond superficial learning. They are digging deep and asking probing follow-up questions, to foster what Harvard Business School's Chris Argyris calls double-loop learning. People must question both their own assumptions and behaviors. Too often, in companies operating with total quality management, managers engage only in single-loop learning. They correct the obvious problem—for example, upon identifying a

cumbersome 275-step product-development process, they streamline the number of steps to seventy-five. However, they don't look into the more insidious problem: Why the company culture allowed managers to condone the buildup of the red tape in the first place.[14]

- Accountable managers are communicating constantly, counteracting the all-too-common culture of confidentiality. They are setting a tone of constant, forthright feedback, uncloaking the facts, good or bad. CEO Mead recalls how, when he joined Tenneco, managers would "hoard" and "rathole" information, if only from inaction. Today, he insists that the quarterly reviews become forums for exchanging improvement ideas. The point is not to obsess over variances but to find ways to close gaps. Accountable managers channel their efforts into praising those who relish gleaning lessons from experience. They want to discourage those who would rather simply trumpet their success and their rivals' failures.

In short, accountable managers are dedicated to reducing the emphasis on using management control systems solely as a means to ask, as consultant Chris Meyer of Integral, Inc., says, "Who's in charge? And who do I nail?" They are emphasizing a discussion of what's wrong and how to fix it. Meyer calls financial command-and-control systems a "silent dog whistle" that, despite executives' talk to the contrary, have trained people to manage to short-term budget numbers.[15]

The experience of managers today shows that a precondition for tapping the power of accountability is revamping this out-of-date culture. Leading managers are setting the example by behaving with candor, trust, and openness. They are showing a zest for sharing, learning, and broad participation. They are making decisions objectively based on hard data. Their work is unifying their organizations' action and spurring organizational creativity and personal development.

To be sure, these managers are using the system in a top-down fashion to make explicit *what* people should do, but they are also using the system in a bottom-up fashion to allow people to show them *how* they can best do it. "Strategy has to be executed from the

bottom up," says David Norton. "The direction starts at the top, but it has to be internalized at the bottom."[16]

THE INFORMATION TECHNOLOGY IMPERATIVE

Managers are also showing today that information technology can make or break effective use of the management planning and control system. In fact, without the rich inventory of data that computers can collect, process, and disseminate, the kind of accountability we talk about would not be possible at all.

One of the reasons management planning and control systems have long focused solely on financials is that they just couldn't handle anything more. They were constrained even when it came to financial data by the demands of collecting, aggregating, and disaggregating data. No system could have handled the amount of data spewed forth today by everything from activity-based cost systems to environmental management systems.

It is only with the information systems today that managers can build the fully accountable organization. These systems, creating a single digital nervous system, give managers a vast new opportunity. Managers can expand measurement and control to many more categories of performance. They can increase real-time monitoring of business initiatives and strategy. They can drill down from corporate-level results to pinpoint the sources of shortfalls. They can quickly capitalize on winning tactics and strategies validated by rapid feedback. In fact, we are only beginning to see the innovations possible with the new capabilities available.

At CIGNA Property & Casualty, President Gerry Isom shows that these new capabilities can lift management planning and control systems to another level of usefulness. For several years, Isom has been able to turn to his desktop computer to quickly review results in fourteen categories, from operating performance to claims management to improving competence. In 1997, he began to put the company's entire strategic information, monitoring, assessment, and feedback system on-line.

Today at CIGNA Property & Casualty, thousands of managers and employees can view their unit's scorecards, the company's scorecard, or any other unit's scorecard, on their computers.[17] They

can study lists of objectives, numerical results, written assessments, and initiatives, each identified by "owner." In effect, they can get a complete picture of where the company and its units' performance is today, as well as its priorities, initiatives, and future goals.

The new system enables people all over the company to take charge of their work. By using the company intranet and browser, they can point and click their way to the specific screens of information they need for their jobs. If they feel unclear about how to support company strategy, they can browse their group's scorecards, study objectives and initiatives, and even read assessments to get a feel for what their bosses want. In this way, says Tom Valerio, senior vice president and transformation officer, the system has begun to answer a question many companies have not yet posed: "How do you connect a strategic tool to the individual?"

As CIGNA Property & Casualty rolls the system out to every employee, it is enabling every person at the bottom to fathom the strategic wishes of Isom and his team at the top. If someone has a question as to how, or if, his or her work furthers the company's strategic thrust, he or she need only grab the computer mouse to find out. If the information isn't available, he or she can send e-mail asking the owner of the initiative for clarification. The system will facilitate two critical obligations of all employees: clarify how their work contributes value to the company and how to align their efforts with the strategy.

Valerio is also counting on the system for one of the most important goals of an accountable organization: unleashing a rich flow of feedback from people throughout the company. On each browser page, employees can click a button to log an idea, complaint, or comment. A claims representative in one unit could read about troubles with an analogous problem in another unit—and in seconds offer lessons from experience that become part of the company's knowledge base. The promise of the system is to significantly shorten the lag time between field learning and management action. "There's more leverage in that dimension [capturing and sharing knowledge] than almost anything else we can do," says Valerio.

Valerio gives an example that shows the potential power of the system. When loss-control engineers recently learned that a scorecard measure was to improve customer retention, they pointed out that they could make an immediate impact. They had once viewed

their jobs only as visiting customers, inspecting conditions, and suggesting changes to reduce accident risks. In the process, however, they often get hints of customer discontent before anyone else does. They realized they could help improve customer retention by alerting underwriters when a customer account appears to be turning sour. Though not their prescribed job, customer retention is something the engineers could align their work with. They could then serve the larger corporate strategy.

Other companies that hope to proceed to full accountability will have to similarly hitch their management planning and control systems to advances in information technology, using software from firms like Oracle, SAP, PeopleSoft, Baan, Lawson, and Gentia. One high-tech firm, N.E.T. Research of Belgium, even offers a product called the "management cockpit," based on SAP software. In one room, flanked by dozens of computer screens, a top manager can track the operations of the entire company, the same way Mission Control tracks a space flight from Houston. Screens show internal and external information like profit, customer satisfaction, brand value, project progress, sales activities, quality of staff, and threats and opportunities. Red lights flash at off-target results. A cockpit officer gives regular briefings.

Information technology also enables many new opportunities in performance reporting to company outsiders. On the one hand, the World Wide Web allows companies to disseminate data immediately, at almost no additional cost. That helps address the long-standing complaint by analysts that performance data arrives on their desks far too late for its timely use. On the other hand, computer power, paired with growing network bandwidth, allows companies to give stakeholders a much broader choice of data. With a point and a few clicks, users can drill down through a corporate website to find the spreadsheet of financial or nonfinancial figures that most closely suits their information needs. A website might also include a range of standard reports, from summary annual reports, to reams of business-segment profit-and-loss data, to a narrative of forward-looking statements of strategy and year-ahead projections.

For dealing with data-hungry outsiders, like financial analysts and public-interest watchdog groups, today's computing and bandwidth capacity also enables a new capability altogether: allowing the downloading of *disaggregated* data, which analysts can manipulate

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