Long before a crisis hits,

Long before it shows in the financials

Or in the KPIs,

The signs are there…

By Tom FitzGerald and John Collins

The CFO AS PREDICTOR OF CORPORATE PERFORMANCE

Dan's eyes were gritty, and he already had the beginnings of a headache. He hadn't slept well, waking several times during the night and finally giving up on sleep long before the alarm went off at 5:15 a.m.

Dan was the CFO of Greycor, a manufacturer of domestic consumer goods. He had been with the company for three years now and was proud of his achievements: Revenues had grown from $36 million annually to more than $250 million. He had also survived the challenges of the Sarbanes-Oxley Act (SOX) implementation and felt that things were going well—until late yesterday, that is, when he got the preliminary Q results.

Now he was scheduled to talk to Marc, his CEO. He wasn't looking forward to it; Marc didn't like surprises. Dan had practiced his opening remarks repeatedly on his trip to the office that day. He hoped that a little humor would ease the pain of what he had to report and perhaps save him from Marc's rarely seen, but legendary, wrath. No such luck.

AS WITH MOST HUMAN DISEASES, A CORPORATE HEART ATTACK—OR EVEN ANGINA—DOESN'T REALLY STRIKE OUT OF THE BLUE WITHOUT EARLIER WARNINGS.

Marc started slowly: "So, you are telling me that our sales have declined precipitously, costs are increasing in both SAG and production, and income has declined by 35% since last quarter? And we're no longer making cost of capital?" Dan nodded unhappily. He started to give Marc some reports that he had been working on late the previous night, but Marc cut him off. "Why didn't you tell me about this earlier?

"We just finished the initial cut yesterday, and I spent most of the night analyzing the results. I came to you as soon as I knew," was Dan's somewhat lame response.

This did little to defuse Marc. "Dan, I want to know three things from you by the end of the week. First, what happened; second, why it happened; third, why I didn't know about it before. I have to start calling board members and our shareholder services area to get in front of this, so go get me my answers. Now."

Dan felt stung and even said, "Marc, I'm just the messenger!"

Marc's response was sharp. "That's not good enough, Dan. The CEO and the CFO both have overall P&L responsibility. I need a CFO who helps me stay in front of the curve, not one who tells me when we're sliding down it. I don't know if we're having a mild case of angina here or a heart attack. Get me my answers by close of business Friday…" He didn't have to finish.

The meeting had lasted nine minutes.

Back at his desk, Dan was haunted by Marc's final question: "Are we looking at a corporate heart attack here? Or is it just angina?"

Dan didn't know. He didn't have the numbers.

As with most human diseases, a corporate heart attack—or even angina—doesn't really strike out of the blue without earlier warnings. They may be silent, they may be subtle, they may be hidden from the casual observer, but the signs and symptoms are there—often for many years. The earliest of these are the *causes* of the disease, the *drivers* of corporate performance. And nothing can predict further ahead than the causes.

All you need to see them—to bring the problems to light—are the correct instruments, which are the business equivalents of the EKG, MRI, and blood tests. And, of course, the courage to look.

THE PHASES OF CORPORATE DECLINE

Dan knew that as a company declines from its peak performance to its end, it goes through three well-documented, clearly identifiable phases:

Phase I—The Hidden Phase,
Phase II—The Subtle Phase, and
Phase III—The Overt Phase.

Each phase has its own clearly defined symptoms and characteristics, and in each phase the company loses a full third of its competitive value (see Figure 1). For this discussion, we're working from the bottom up and from right to left in Figure 1.

Phase III Decline—The Overt Phase

When Dan presented the financials that morning, he was careful to tell Marc that, even though they were still profitable, the company was no longer making cost of capital, something that would, and should, trigger intense board concern. Frequently this stage is referred to as "Early Decline"—definitely a misnomer. Both Dan and Marc recognized it for what it really was—the earliest stage of Phase III Decline: two-thirds of the way down the curve. Their board, being professionals, would know this, too.

By the time the signs of decline first show in the financial statements (right column of Figure 1), Phase III Decline has arrived. And with its arrival, two-thirds of a company's competitive value has been lost.

Their company had gotten there without apparent warning and without either of them knowing how. Both knew that running a company from the financial statements—however timely the statements are—is like driving a car by looking only in the rearview mirror: By the time problems show there, the car is already deep in trouble. Dan had produced the financials the fastest they had ever been produced, but they were still no better than the rearview mirror.

No difficulties had shown up in the previous periods' financials either. No hint, no suggestion. If the company's systems had been better, Dan might have been able to get some kind of warning from the Z or ZZ Scores. But in their case it wouldn't have been much—a couple of months perhaps—and those measures were iffy for their industry anyway.

Phase II Decline—The Subtle Phase

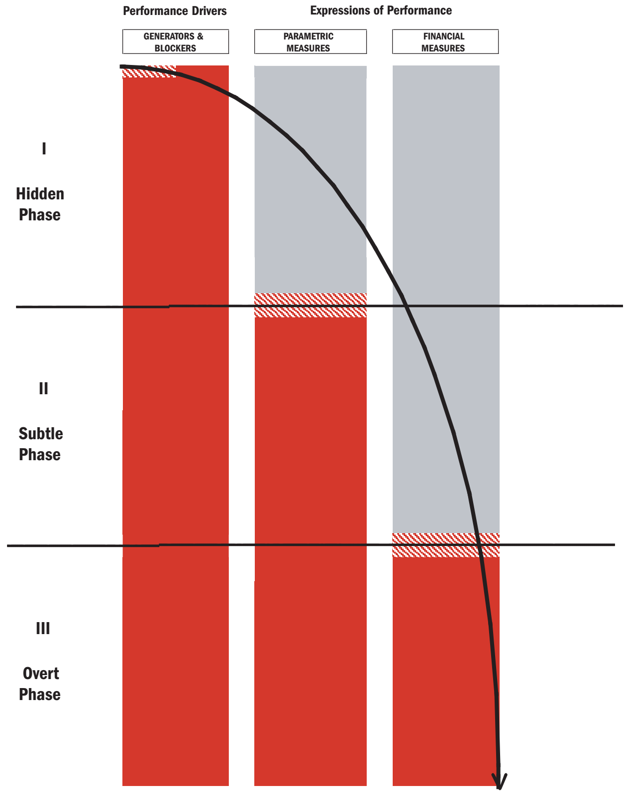
Things would have been different, Dan thought, if they had recognized earlier, perhaps a year before, that they were in Phase II Decline and heading down. But Phase II can't be seen from the financials, even with the most sophisticated analysis possible. Detection of Phase II requires different measures.

Phase II Decline shows in the parametrics or key performance indicators (KPIs)—middle column of Figure 1—things like time to market, process metrics, and customer complaints. Like the financials, these factors are *historic* expressions of performance, but at least they are earlier historic measures. KPIs are things that a professional due diligence would have picked up if the company had been for sale. (There's another measure, too, but we'll talk about it later.)

There was plenty of information available in the literature about KPIs and their measures. Dan knew what needed to be measured and how, but he hadn't been able to develop the measures yet. The KPIs that Greycor had been measuring before he came were conflicting and had set the goals of one department against another, particularly manufacturing, QA, and sales. The proper ones were difficult and expensive to measure. They had been on his department's wish list for next year, but now, unless things got better, the company wouldn't have the resources to develop them.

Dan did admit to himself that there were some *guesses* the senior staff could have made about some of the KPIs that would have raised alarms—guesses that he now allowed would have been close to the truth. But he hadn't asked the group for any information, perhaps because he

Figure 1: STAGES AND MEASURES OF CORPORATE DECLINE



hadn't felt empowered as CFO or perhaps, as a CFO, he was used to measuring only hard (i.e., financial) numbers.

Yet managing a company from the KPIs, even timely ones, is no better than driving a car by looking out the side window. Yes, it's better than the rearview mirror, but by the time trouble shows there, the front of the car, at the very least, is nose deep in trouble.

By the time Phase II shows up, fully a third of a company's competitive value has been lost. Dan had been in this situation before, and he knew that the loss had already occurred in Phase I. While not quantifiable by a due diligence in terms of money, the deficiency would show up the moment the company needed to respond to a crisis or mobilize itself for a new endeavor. A demoralized army team was the analogy Dan used to himself.

What the company needed was a set of measures that would indicate problems at the earliest stage possible—at the very beginning of Phase I. These were measures that would allow Dan to go to Marc and say, "Here are the financials; they look good." Maybe also, when they could afford them, "Here are the KPIs; they look good, too." But then he needed to be able to add, "Here are some numbers that show a problem coming, a problem that will manifest itself in the KPIs and in the financials soon after that...*unless we do something*."

As Dan thought about it, signs like these had been evident in the way the company had been running since he arrived. He suspected they had been there for years—since before Marc had arrived, too. He just hadn't seen them as being important and certainly not related to the nasty runoff of their more profitable customers that had shown itself suddenly.

He quietly admitted to himself that the customer problem was driven by a deterioration in management performance, whose impact had not been understood. It wasn't his place to say that, he supposed, but he would now. And he would take heat for it. But Marc was a CEO with enough guts to look reality in the eye and have his team look at it, too.

MEASURING JUST THESE THREE GENERATORS OF PERFORMANCE SHOWS CLEARLY THE COMPETITIVE TRAJECTORY—DOWN OR UP, FAST OR SLOW…

Phase I Decline—The Hidden Phase

The signs and symptoms that show Phase I Decline are company attributes called the Drivers of Performance (left column of Figure 1). Collectively they constitute the operating dynamic of the company, and they are entirely within management's control. They are the very causes of performance. And, since no problem can be predicted further ahead than its *cause*, these drivers are the very first predictors.

Performance drivers fall into three categories: Critical Functions, Generators of Performance, and Blockers of Performance.

CRITICAL FUNCTIONS

Critical Functions are those functions within a company that have a large effect on productivity with very little effort. An analogy would be the accelerator on a car. There are only a handful of these Critical Functions, and they can be measured very easily. There are six, but we will deal with just three here:

- **Talent Management,**
- **Lean Operations, and**
- **Performance Management.**

Talent Management refers to purposeful hiring, development, and turnover. Lean Operations includes cost containment, lean manufacturing, etc. Performance Management refers to goal setting, rigorous follow-up, rewards related directly to performance, and the like.

We chose these three because they are important and because, a few months ago, the results of an eight-year study of 100 companies by the London School of Economics and McKinsey & Co. showed conclusively the extraordinary impact these three Critical Functions have on the bottom line. (See *When It Lifts Productivity*, Stephen J. Dorgan & John J. Dowdy, © 2005 McKinsey & Co. Or to request a summary, see "Sample Questions" on p. 45.)

All companies have Critical Functions. They are independent of any systems and processes, and, as is worth mentioning again, they are entirely within management's control.

From the moment he arrived, Dan had been aware at some level that these Critical Functions were faltering in Greycor. The quality of their execution and enforcement of all three were generally poor throughout the organization.

Quantifying the Critical Functions. Even just quantifying Talent Management, Lean Operations, and Performance Management provides a clear assessment of where a company stands. And if the company is in decline, they show broadly (by their measured values) whether it is in Phase I, II, or III. They also show where a company is on the growth-development side, but we won't cover that here.

Measuring the Critical Functions provides a value for the effectiveness of management (as a whole) as it impacts a company. *This measured value is the full analog of the financial balance sheet*. The difference: While the financial balance sheet is a historic measure, the effectiveness of management (today) is what is creating the performance of the company tomorrow.

If Dan had measured the Critical Functions the month before, when the financials showed no trouble, they would have told him the company was somewhere near the bottom of Phase II even though there were no measurements of KPIs to ring bells. And that would have been a signal to at least canvass management and key staff as to where they thought the company was heading.

If he had measured the Critical Functions a year before (or perhaps two or three), they would have shown clearly that the company was already in Phase II Decline and how deeply.

PERFORMANCE GENERATORS

Underlying the Critical Functions and determining their effectiveness are nine attributes of management. We call them the Generators of Performance, and they can be measured easily. While the Critical Functions are the analog of the balance sheet, the Generators are the analog of the P&L. They show the trajectory and rate of change of the Critical Functions.

For simplicity, we will deal with just three here:

- **Decisiveness,**
- **Acknowledgment of Work, and**
- **Accountability.**

Decisiveness here refers to the decisiveness of the company: the speed with which issues are brought to the table, decided upon, and executed. It doesn't refer to the decisiveness of the CEO or manager or to the quality of decision making. (For the same quality of decisions there is a huge variation available in the rapidity of decision making; e.g., it's possible to make 10 decisions or 20 decisions of the same quality in the same time frame, depending on the decisiveness of management.)

Acknowledgment of Work may seem like an odd factor to examine. This Generator refers to the amount, frequency, and quality of discussions between workers, between workers and supervisors, between supervisors and management, and between all and clients and suppliers. When Acknowledgment of Work is poor, supervisors aren't talking with their subordinates about that work. Therefore, there's no feedback or hope for improvement.

Accountability doesn't require a definition.

These three Generators profoundly determine the effectiveness of the Critical Functions. For example, if Accountability is deficient, neither Talent Management nor Cost Containment can operate well.

Measuring just these three shows clearly, if not in fine detail, the competitive trajectory—down or up, fast or slow—and the rate of change of the Critical Functions—how fast or slow they are improving or deteriorating.

To Dan, Decisiveness was the major issue among the Generators; it affected all the Critical Functions. If he had identified and quantified that, he could have told how quickly competitive and financial problems were approaching. And he could have gotten very good answers from the managers and supervisors if he had just asked the right questions. They usually see the Generators very clearly, even if they don't like to think about them.

Once the Critical Functions and Generators are measured, it's very difficult for management or the board to ignore them. The measurements provide the basis for reward and intervention. If given to investors, they provide information on whether to buy, avoid, or sell.

PERFORMANCE BLOCKERS

Only six Critical Functions and nine Generators need to be measured to get the current value (balance sheet) and trajectory (P&L) for the effectiveness of management. But now for the bad news: There are more than 100 possible factors within an organization that can block or impair the Critical Functions and the Generators. They are known as Blockers—the organizational factors that suck the lifeblood out of a company. The profile of Blockers is unique to each organization and even to each unit within. Because of the complexity in dealing with Blockers, we'll mention only three here that need no definition: Distrust, Complacency, and Bureaucracy. Dan thought that Bureaucracy might be the biggest one for Greycor because it blocked decision making, which crippled all the Critical Functions.

SAMPLE QUESTIONS

Q. We attract and retain the best people. Talent Management (a Critical Function)

Q. Our managers hold each other accountable. Accountability (a Generator)

Q. Our managers are reluctant to speak their minds. Distrust (a Blocker)

For additional examples or access to a summary of the LSE/McKinsey report, contact Tom FitzGerald at fitz@managementconsultants.com.

MEASURING DRIVERS

Quantifying the Critical Functions gives the value (balance sheet) of a company's *management effectiveness*. Quantifying the Generators gives the *trajectory* of the Critical Functions (P&L). Quantifying the Blockers explains *why* the Critical Functions and the Generators are as they are and, by direct inference, how to fix them.

So, how do we measure these Critical Functions and Generators? All you need is a simple survey, and its construction and use are easy.

1. Create a questionnaire. To do this properly, each driver requires between three and 10 questions (statements) to capture its full spectrum. But one or two will do for a start. (See "Sample Questions" on p. 45.) Dan measured all 15.

2. Issue the survey to all managers, supervisors, and key staff, from the CEO down, by team. Ensure that it is anonymous within each team. Dan had 10 teams to survey.

3. Score so that the Critical Functions and Generators are expressed in a range from -5 to +5.

4. Sum and average appropriately.

5. Have the senior team (CEO plus immediate reports) confront the responses together as a team. Have the subordinate teams confront their issues in separate sessions. A professional outside business catalyst/intervener is desirable for this. Note that not all facilitators are catalyst/interveners.

ON THE ROAD TO RECOVERY

For many years, C-level executives have complained that there were no instruments or measures that would provide them with a clear picture of the current effectiveness of management, that would show its trajectory, and that would enable them to predict future workforce or financial performance. They also complained that there were no tools for them to use to change that performance.

For many years they were right.

But in 1980, our company discovered that the very causes of performance—the organizational and human factors that are the wellsprings of all business outcomes—could be quantified. The tools we use (the corporate 360° series of surveys) measure the effectiveness of management (not individual managers) unit by unit and for the whole company, just as the KPIs and the financials do. This was the first time such measures were possible. (As an aside, just as the traditional 360° appraisal is a measure of an individual manager's performance, the tools developed to measure the causes of performance are 360° appraisals of the whole organization—from within.)

Even more interesting, the measures predict a company's workforce performance and bottom line far into the future. Management effectiveness is the root of all performance; current management performance is that which generates future corporate performance—both KPI and financial. Most interesting of all—a discovery of extraordinary potential for any CEO—the factors measured had within them the seeds of their own improvement. As all CFOs know, managements can, and often do, ignore financial warnings as well as those from KPIs. Yet measures of management effectiveness seem to generate the energy and willingness to make changes.

Without these measures, both CEO and CFO must travel blind. With them, the CFO can be a prophet, and the CEO can preempt trouble. Together they can change the future.

Dan set to work on a survey. The accounting department prepared the financials, which showed the company's performance as it had been. Now he would add measures that would enable the company to make predictions—and it would cost virtually nothing.

His first task would be to measure the Critical Functions and the Generators since they were the easiest. He would issue the survey along with the LSE-McKinsey study. That would take care of any legitimate reluctance among managers because from it *they would know that improving just three functions by 20% would get them a 40% improvement in profits*. Even a 10% bottom-line improvement would take them out of trouble. Then he would get to the much more challenging Blockers. But that would be for another day, another survey. ■

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