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In the dark II:

What many boards and executives STILL don't know about the health of their businesses

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Survey background

There is no escaping the value of financial metrics; there is no escaping the need to generate financial returns.

But for some time now, executives have been examining the ways that they might better understand the health of their organizations and improve overall performance—financial performance included—by focusing some of their attention on non-financial measurements.

Business leaders have long understood that what you measure is what you get. Money drives markets, so the financial measurements that drive company valuations produce the precise sort of return-focused behavior expected by most investors.

Few would deny this, but are metrics such as cash flow, sales or earnings the true determinants of corporate performance or a means of scoring the success of less financially focused business activities and strategies? It is from this perspective that business executives, always in search of a competitive edge, are asking increasingly sophisticated questions about performance measurement.

For example:

- Do current performance measurement programs adequately inform and assist decision-making by the board and senior management?
- Is a focus solely on financial metrics the best way to drive performance?
- Are there certain non-financial indicators that so closely correlate with financial performance that they are in fact leading indicators of that performance?
- Could a greater focus on certain non-financial metrics actually improve financial performance?
- To what degree is financial performance driven by customer satisfaction or employee engagement?
- Are there risks in failing to measure or report progress on issues of corporate social responsibility?
- Can performance be improved by assessing the organization according to a more balanced mix of both financial and non-financial objectives?
- Do certain carefully selected non-financial performance measurements offer management, and even investors, a more useful set of *leading* indicators than financial measurements?

In 2004, Deloitte Touche Tohmatsu (DTT), in cooperation with the Economist Intelligence Unit, examined these issues and published the findings in a report titled *"In the Dark: What boards and executives don't know about the health of their businesses."* In March and April 2004, the Economist Intelligence Unit surveyed 249 senior executives and board members around the world and interviewed a number of corporate directors in North America, Europe and Asia. The report concluded: "While the overwhelming majority of board members and senior executives say they need incisive non-financial information on their companies' key drivers of success, they largely find such data to be lacking or, when available, of mediocre to poor value."

Almost three years later, Deloitte and the Economist Intelligence Unit worked together to see whether things had changed and conducted the research along much the same lines as before. A global survey fielded in December 2006 obtained responses from 175 senior executives and board members. Then, through January 2007, in-depth telephone interviews were conducted with senior executives and board members at large companies.

The questions and the multiple choices of the second survey were based on, but not exactly the same as, the first questionnaire. Also, the respondents in the two surveys varied. While the statistical results are not directly comparable number for number, the broad observations and trends are clear.

Survey highlights

The broad trends seen in this 2007 survey* are remarkably similar to those from the 2004 survey. Many board members and senior executives are still in the dark about the overall health of their organizations and have a lack of high-quality non-financial data that they can act upon. As with the first survey, corporate leaders believe that it is extremely important to monitor non-financial indicators such as customer satisfaction and employee commitment, but many admit that their firms do a much poorer job at measuring these indicators than at gathering and analyzing financial data.

The picture is not entirely bleak, however. The results of the second survey indicate that a growing number of companies are indeed creating significant value for their organizations by starting to understand their underlying performance drivers through the use of non-financial measurements.

Overall, this survey casts fresh light on these issues, suggesting that businesses are continuing to focus on financial indicators, while paying more attention to other performance measures. Achieving a better balance between financial and non-financial performance should not entail paying less attention to the former, but instead paying proper attention to both.

Some key findings include:

(1) Existing performance measurement frameworks are inadequate, and the majority of executives perceive a growing need to better understand the underlying drivers of their performance through non-financial measurements.

- Eighty-three percent of respondents say the market itself increasingly emphasizes non-financial performance measures—a figure that rises to 87 percent of respondents at companies with US$1billion or more in revenues.

- Among those respondents, over three quarters (78 percent) say that financial indicators alone do not adequately capture their companies' strengths and weaknesses. The figure rises to 85 percent of respondents at companies with over US$1billion in revenues.

- Sixty-nine percent say that it is the responsibility of the board to monitor both non-financial and financial measures of performance.

- Fifty-seven percent say their companies are under increasing pressure to measure non-financial indicators.

(2) Though companies are aware of the pitfalls of focusing exclusively on financial performance, the ability of executives to measure and monitor performance through non-financial measurements appears to be inadequate. Companies either do not have or are not sharing critical non-financial performance data with their boards.

- Most companies give themselves high marks in terms of their ability to track financial performance, with 87 percent describing their record as either excellent (43 percent) or good (44 percent). By contrast, only 29 percent describe their ability to track non-financial performance as either excellent (5 percent) or good (24 percent). Meanwhile, over a third (34 percent) describe their non-financial records as merely fair (21 percent) or poor (13 percent).

- The quality of non-financial performance data available to companies is inadequate in relation to the perceived need for it. Customer satisfaction, operational performance, innovation and employee commitment are identified as key drivers of performance. Yet only a minority of companies describe the quality of corresponding information provided to the board in these areas as excellent. In many cases, notably in the case of employee engagement and innovation, more executives describe the quality of information provided as poor compared to excellent.

- The board is not the only entity that is "in the dark" relating to non-financial performance measurements. Significant percentages of respondents say that senior management also needs better information relating to such areas as employee commitment (58 percent), customer satisfaction (48 percent), innovation (36 percent), the quality of governance (35 percent), impact on society (32 percent), operational performance (31 percent) and supply chain/alliance partner performance (31 percent).

- By contrast, only 20 percent of respondents see the need for improvement in the reporting of financial results. This highlights the point that even amid significant dissatisfaction with the breadth and quality of non-financial information, executives are largely satisfied with the quality of their financial metrics.

The 2004 survey found a similarly large gap between the perceived quality of financial and non-financial indicators. While 86 percent said their company was excellent or good at measuring and monitoring financial performance indicators, only about one-third said they were so at non-financial performance measures. Some 40 percent rated themselves average at measuring and monitoring non-financial indicators, while nearly a quarter called themselves fair or poor. Almost half said the company's non-financial metrics were ineffective in helping the board and the CEO make long-term decisions. About one-third said non-financial metrics were ineffective or highly ineffective in helping directors and the CEO with control and compliance matters.

* While the 2007 survey explores many of the issues examined in our 2004 report, the surveys were not identical; therefore, specific comparisons between the studies would not be statistically valid. The findings are, however, remarkably comparable in magnitude.

(3) Despite the dissatisfaction with the quality of non-financial measurements of performance, current impediments to the broader use and greater sophistication of non-financial performance metrics include undeveloped tools, organizational skepticism relating to the value of these tools, unclear accountability for non-financial performance, time constraints and the concern that such metrics may convey too much information to competitors. When asked to identify the triggers most likely to spur their organization to reassess how it measures and monitors performance:

- Fifty-four percent of respondents say that a greater understanding of how to measure non-financial drivers of performance would spur a reassessment of how their company measures and monitors performance.

- Forty-five percent say that a sharp decline in customer retention or customer satisfaction—a near-crisis—would be a trigger to reassess the way their company measures and monitors performance.

- Forty-three percent say this reassessment could be triggered by a demand from a board member or the CEO for greater visibility and accountability.

- Other "events" that might prompt action include: the competition for capital dictating expanded reporting and more stringent control (22 percent); a significant increase in competition (21 percent); a major compliance failure (21 percent); or a sharp decline in employee satisfaction/retention (16 percent).

According to the 2004 report, the two biggest obstacles to enabling the board and senior management to track key non-financial vital signs of the business are the lack of developed tools for analyzing such measures (59 percent) and skepticism that such measures are directly related to the bottom line (40 percent). No other barrier was cited by more than about a quarter of the companies.

Overcoming the obstacles appears to require significant changes in corporate governance. Companies that were excelling at monitoring both their financial and non-financial performance were much more likely than companies that were struggling at this to do three things well: a) believe that non-financial measures do affect company profitability; b) have board members and executives who are comfortable with and knowledgeable about non-financial measures; and c) combine good measures with rewards.

(4) Nevertheless, in time a growing number of companies will improve the quality of their non-financial performance measurements and adopt them more broadly in the enterprise.

- Companies are feeling pressured to expand their use of non-financial performance metrics. But in addition, a growing number of executives also see numerous potential advantages to pursuing non-financial performance metrics.

For example, 37 percent say their company's performance is determined more by intangible assets/capabilities (e.g., employee engagement, customer loyalty or innovative capabilities) than by hard assets.

Similarly, 54 percent say forward-looking information is of greater value to management and the board than historical information.

- Through internal and external forces, companies are being driven to increase the emphasis on non-financial performance measures.

When respondents were asked to rank the most important non-financial drivers of corporate performance, they chose, in order of frequency of citation: Increasing reputational risk; increasing customer influence; increasing global competition; increasing regulatory emphasis on non-financial measures; accelerating innovation; greater scrutiny of non-financial performance measures by the media; increasing power of NGOs, lobbyists and civic organizations.

In the 2004 report, the majority (73 percent) of the executives and board directors said their companies were under increasing pressure to measure non-financial performance indicators. Indeed, almost all those surveyed said that a number of key areas of their business in which health cannot be measured in monetary terms were critical or important drivers of success: such as customer satisfaction (71 percent), product/service quality (62 percent), operational performance (52 percent), and employee commitment (50 percent).

As companies gain experience with non-financial metrics, they discover a wide range of predictive, forward-looking managerial tools (a consequence detailed by this report's accompanying interviews and case studies).

The earlier survey also showed that there was a growing mandate for better oversight of companies. Investors were placing greater emphasis on sustainable long-term growth (72 percent), and there was a realization that forward-looking information was of greater value to management than historical data (73 percent).

According to those interviewed in 2007, the value of non-financial metrics is even more important than just a few years ago. For example, Jay Lorsch, a non-executive director at CA, Inc. and a professor at Harvard Business School, was interviewed for both the 2004 and the 2007 reports. According to Mr. Lorsch, "While the emphasis is still too heavily skewed to financial results, there's been a great deal of progress." There are some leading companies, says Mr. Lorsch, "who are using more and getting more value from non-traditional metrics."

Non-financial metrics: The quest for greater insight

Do current performance measurement programs adequately inform and assist the board and senior management in making decisions? Are financial metrics the best means of driving performance? Could a tighter focus on certain non-financial metrics actually improve performance? Should companies seek a better balance between financial and non-financial metrics? The survey results and accompanying interviews show that the majority of companies are expanding their use of non-financial performance metrics.

By paying attention nearly exclusively to financial performance, says Martin Carver, Chairman, President and CEO of Bandag, Inc., an American supplier of tire products, many boards and executive teams miss some important insights. The fact is, says Mr. Carver, "it's the non-financial metrics that are probably more important than the financial metrics."

For example, "What drives your cash flow?" Mr. Carver asks. "It's your employee commitment. It's your customer satisfaction." But the problem here, he says, "is that those things are extremely hard to measure and even more difficult to promote or achieve." Consequently, says Mr. Carver, many boards and management teams "have very little insight into some of the most influential processes in their businesses."

A realization emerges

Bandag's CEO is not alone in his views. The survey reveals a strong desire to develop and use non-financial performance metrics. For example, 83 percent of respondents say the market itself increasingly emphasizes non-financial performance measures—a figure that rises to 87 percent of respondents at companies with US$1billion or more in revenues.

Closely related findings include:

- Over three-quarters (78 percent) of survey respondents say that financial indicators alone do not adequately capture their companies' strengths and weaknesses. This figure rises to 85 percent of respondents among companies with over US$1billion in revenues.

- Fifty-seven percent of survey respondents say their companies are under increasing pressure to measure non-financial indicators. However, among non-executive directors, the figure falls to only 37 percent.

- Sixty-nine percent of those surveyed say that it is the responsibility of the board to monitor both non-financial and financial measures of performance.

What's driving the trend?

The above statistics leave little doubt that companies are under pressure to increase the use of non-financial performance metrics. The survey provided several reasons for this.

The survey tests executives' broad perceptions of the most influential forces behind the trend. Asked to cite what they view as the primary drivers behind the marketplace's growing use of non-financial performance metrics, the resulting list (in order of frequency of citation) includes:

- *Increasing reputational risk*
  Forty-nine percent of respondents and 59 percent of those whose companies have annual revenues of over US$1billion—believe that companies are turning to non-financial performance metrics to help them avoid damage to their reputations.

Such damage can be real, says Dr. Walter Massey, President of Morehouse College in Atlanta, Georgia, and a member of the board at British Petroleum, McDonald's and Bank of America. For example, according to Dr. Massey, "there are more investment firms than ever before that are attaching importance to non-financial performance." So when it comes to areas such as business ethics, environmental stewardship or corporate social responsibility (CSR), Dr. Massey believes that "if you don't manage these issues, it can now have a direct impact on sales, investment and share price."

As for the role of board members, Dr. Massey's view is that "if they're not taking these non-financial objectives seriously, if they're not reviewing performance in these areas, then they're not doing their job."

Still, Dr. Massey is quick to point out that in his experience most companies are beginning to "get it." As he explains, "The executives I know are paying much closer attention to these issues. They either have committees dedicated to these issues, or they're getting them organized."

- *Increasing customer influence*
  The next most influential force is the degree to which customers are gaining influence in the marketplace, a driver cited by 40 percent of respondents. Thanks in part to the Internet, customers have greater power than before, and companies are finding they need to learn more about the customer's needs and desires. In addition, says Dr. Massey, "the ranks of the ecologically minded, socially minded consumer are growing, and companies run considerable risks if they don't pay attention."

- *Increasing global competition*
  Thirty-eight percent of respondents believe that increasing global competition is one of the principal drivers. For example, with so many international and domestic companies now competing for talent in China, Elizabeth Martin-Chua, SVP HR for Philips China, says that her company is now looking more closely at issues in human capital management.

"Financial performance is very important, and we discuss this with our managers and it is in their performance review" says Ms. Martin-Chua. But with talent acquisition and retention becoming critical determinants of success, "we are spending much more time discussing people issues."

Here, says Ms. Martin-Chua, "it is very important that there is a process and that managers engage in the process." So the company conducts regular reviews with every manager "and we make a point to ask what they are doing with their people? Are they retaining their people? How is their recruiting and development? What is the situation?"

Ms. Martin-Chua says it is challenging but essential to make non-financial issues matter. "But the way to make this work is to be consistent and to make it important to the managers." She says that with reinforcement, "we are able to keep this non-financial goal on the managers' agenda".

- *Increased regulatory emphasis on non-financial measures* Nearly a third of the executives surveyed (32 percent) believe regulators are causing companies to pay more attention to non-financial performance metrics. The figure rises to 37 percent for respondents from companies with over US$1billion in revenues. Here, says Mr. Lorsch, "there is certainly a trend toward greater visibility."

Adds Pedro Reinhard, the former EVP and CFO of Dow Chemical and now a member of the board at Dow Chemical, Royal Bank of Canada, Colgate-Palmolive and Sigma-Aldrich, "Regulators and investors are always going to want more information; more transparency." But he asks, "Just how useful is this additional reporting?" adding, "Isn't there a point where you're just giving too much information to the competition?"

Note that forty-nine percent of executive directors say that reputational risk is a primary driver, compared to only 38 percent of non-executive directors. Similarly, over a third of executive directors, 35 percent, view increased media scrutiny of non-financial performance as a critical driver, compared to only 13 percent of non-executive directors. The conclusion: it appears that non-executive directors severely discount reputational risk.

- *Accelerating innovation*
  Twenty-nine percent of respondents say that the need to make more innovative products and services is another force behind the increasing interest in non-financial performance metrics. But J. Marvin Quin, SVP and CFO at Ashland Inc., a diversified chemical company, says finding the right metrics is a continuing challenge. "We're trying to do more to measure and promote innovation," he explains. For example, "We are looking at the percentage of products sold that are new and using that to see how aggressively we are refreshing and updating our products."

Admittedly, says Mr. Quin, though the measure creates a useful index, it is not necessarily a precise instrument. "We have to be careful using this in comparison to competitors because the ways companies define new products tends to differ." Is a product change developed for and delivered to a single customer a new product or is that just a differentiation? "There's a lot of grayness," says Mr. Quin, "so you have to define what you mean, what you're looking for, and look very closely at the results."

- *Greater scrutiny of non-financial performance measures by the media*
  Twenty-six percent of respondents view expanding media coverage of non-financial performance as another significant driver. Increasingly, says Dr. Massey, "media and the business press are providing a lot more structured and in-depth coverage of non-financial issues such as ethics and social responsibility." Negative publicity in such areas can do "real harm" to a company; conversely, positive press coverage can boost the bottom line.

- *Increasing power of NGOs, lobbyists and civic organizations*
  Closely related to the growing influence of socially minded consumers, 16 percent of respondents feel these CSR-oriented groups create incentives for companies to measure and manage related issues.

But this is not to say that all executives believe that outside pressure is driving corporations to do more to measure this area. As Debbie Whitaker, Group Head, People Product Management at Standard Chartered Bank explains, "We've always been a very diverse organization, but about a year ago, we started a much more structured approach to both tracking gender or various nationality groupings and increasing the diversity of our talent pools."

However, says Ms. Whitaker, the motivation has nothing to do with outside pressure. "We do this not because anyone's telling us we have to—we're doing it because we believe it not only will make us a stronger company, it's just the right thing to do."

Other forces
Of course, there are additional drivers behind the increasing use of non-financial performance metrics. One of the most prominent, says David Norton, SVP Relationship Marketing at Harrah's Entertainment, "is the way that more companies are realizing how non-financial metrics drive financial performance."

For example, perhaps nowhere is the growth of customer power more evident than in the casino business. "Success in our business," says Mr. Norton, "depends on meeting or exceeding the expectations of our customers. If we don't, they go somewhere else. So yes, we're customer-focused."

Certainly, financial indicators have their place, says Mr. Norton. But what his company has learned "is that the ways we capture, analyze and respond to trends in customer data are absolutely critical to our performance." For example, "for a number of years now, we've been collecting and studying customer satisfaction data in a lot of detail: differentiated by business unit, by tiers of customers and by other criteria."

What the company is learning, says Mr. Norton, "is that things like the grades we assign to customer satisfaction, based on all that detail, are a better predictor of earnings from an individual customer or for a business unit than almost anything else we've considered. Our revenues directly correlate to our customer satisfaction."

Armed with these insights, Harrah's turns its customer data into actionable intelligence. For example, "If we see scores falling at a particular property or if we notice a drop among a certain tier of customers, the property managers or the customer service directors can see that and can respond accordingly." So in effect, says Mr. Norton, "this customer data is a very practical leading indicator, something we can use to improve the customer experience." That in turn, says Mr. Norton, "drives our revenues."

The number of respondents saying innovation needs are driving the use of non-financial metrics is slighter higher (32 percent) at companies with under US$1billion in revenue; slightly lower (27 percent) at companies with over US$1billion.

The current state of oversight

The survey and accompanying interviews show that non-financial performance metrics are becoming more important—even vital in some cases. It should follow, then, that managers and board members are enhancing their efforts to identify, track and benefit from such measures.

On the contrary, the survey instead reveals a significant gap between the stated perceived importance of non-financial goals and objectives and the corresponding practices for tracking and managing non-financial performance metrics. Our research in 2004 found the same disconnect between rhetoric and reality.

The non-sequitur

There can be no doubt that executives perceive the growing importance of non-financial metrics. The previous section of this report reveals that a majority of survey participants believe that: (a) the marketplace is emphasizing non-financial performance measures; (b) financial indicators do not adequately capture all of a company's strengths and weaknesses; and (c) boards should be held responsible for tracking both financial and non-financial performance.

Accordingly, the survey results would be expected to show that organizations are enhancing their ability to measure, track and manage a broad range of non-financial goals and objectives.

But in fact, the survey shows that companies continue overwhelmingly to focus primarily on financial objectives and metrics.

For example, respondents were asked to rate their organization's record of measuring and monitoring financial and non-financial aspects of performance. Regarding financial performance, most companies surveyed gave themselves high marks, with 87 percent describing their record as either excellent (43 percent) or good (44 percent).

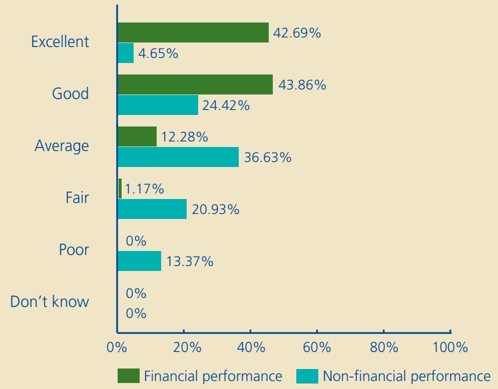
But in stark contrast, regarding the measuring and monitoring of non-financial performance, only 29 percent describe their record as either excellent (5 percent) or good (24 percent). Furthermore, 34 percent describe their records as merely fair (21 percent) or poor (13 percent).

These findings are not surprising, says Bandag's Mr. Carver. Executives, he explains, "tend to focus on financial metrics because that's the easy thing to do." The problem, says Mr. Carver, is endemic. "Everyone seems to have this idea that accounting is a science, and so you can measure results quarter to quarter with precision to somehow see where you're going long-term."

But according to Mr. Carver, business performance over the longer term "is subject to competition and chaos." So while cash flow and profits provide insights into the immediate and short-term health of a business, Mr. Carver maintains that such financial details tell a board or a company's investors very little about the long-term prospects.

Ultimately, says Mr. Carver, "It's the non-financial performance metrics—employee commitment, effectiveness, and passion, customer delight and loyalty and the other sorts of process indicators that accountants haven't learned to measure—that can give you a better prediction of the long-term and sustainable competitive advantage."

16. How would you rate your organization's record of measuring and monitoring financial and non-financial aspects of performance?



Recognition but no action

What the above statistics and commentary begin to show is that many companies have yet to align their practices with their beliefs. Though the majority of respondents say non-financial metrics are becoming more important, many if not most still treat the development, monitoring and dissemination of non-financial metrics as an afterthought.

For a more detailed view of this phenomenon, compare those areas deemed key drivers of success with the quality of corresponding information shared with the board.

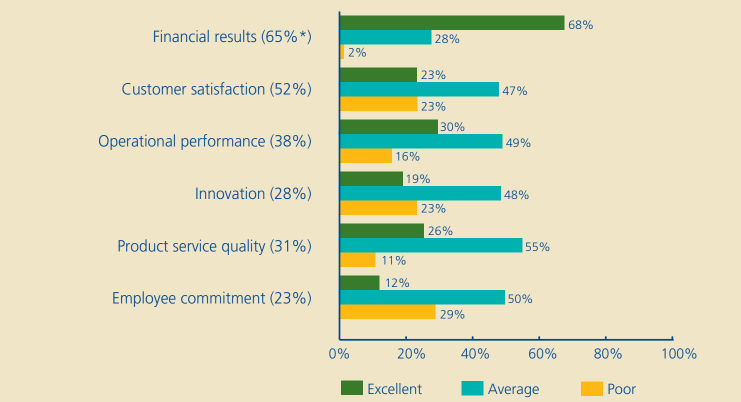
The greatest numbers of respondents (65 percent) say financial results are important drivers of success. So it is no surprise that 68 percent describe the quality of corresponding financial information shared with the board as excellent.

But certain categories of corporate performance rank highly on respondents' lists as drivers of success, including customer satisfaction (52 percent), operational performance quality (38 percent) and employee commitment (23 percent). That is, respondents recognize these are important drivers. Nonetheless, most executives say their boards are not receiving information of commensurate quality—and certainly they are not receiving the quality of information befitting a key driver of corporate success. In other words, there is recognition of the opportunity, but little action. (See Table A1 and A2.)

Table A1
It may drive success, but the board doesn't see it….

A side-by-side comparison shows that while companies gives themselves high marks for the quality of financial information provided to the board, the self-assessment scores fall sharply when it comes to the quality of non-financial metrics.

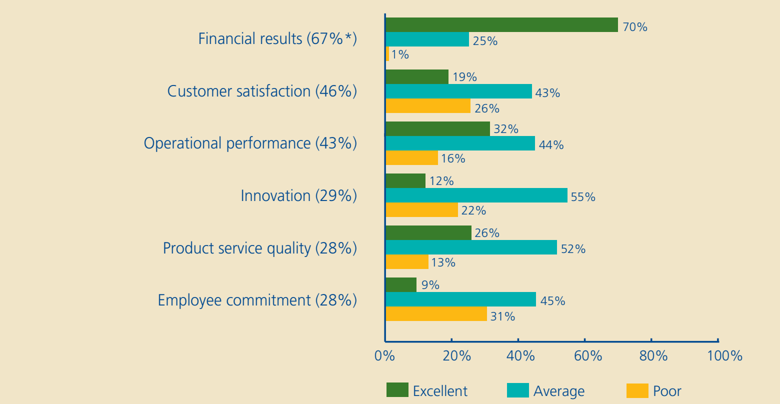
Quality of corresponding information shared with the board



* Percentages in this column = number of executives citing this category of performance as a key driver of success (Q9/Q14)

At the largest companies, those with revenues over US$1billion, the disconnect between key drivers of success and the quality of information shared with the board becomes even larger. (In particular, note customer satisfaction and innovation.)

Table A2
Companies with revenues over US$1billion



* Percentages in this column = number of executives citing this category of performance as a key driver of success (Q9/Q14)

Prioritization

The board may not be the only part of the company operating in the dark. When it comes to non-financial performance measurements, the survey reveals that senior managers may also need better quality information.

In particular, significant percentages of survey respondents say senior managers need better information in such areas as employee commitment (58 percent), customer satisfaction (48 percent), innovation (36 percent), the quality of governance (35 percent), impacts on society (32 percent), operational performance (31 percent) and supply chain/alliance partner performance (31 percent). (Companies with revenues of over US$1billion place particular emphasis on the need for better information regarding employee commitment (64 percent) and customer satisfaction (56 percent).

By contrast, only 20 percent of respondents see the need for improvement in the reporting of financial results. This again highlights that even amid significant dissatisfaction with the breadth and quality of non-financial information, executives are largely satisfied with the quality of their information related to reporting financial results.

Financial vs. non-financial performance metrics

The survey clearly shows that information needs are not being met. Executives were asked whether their company's financial metrics were effective in supporting the efforts of the board and senior management to achieve various business objectives. In virtually every case, a significant number of respondents said their financial metrics were not effective.

Would non-financial metrics therefore help to close the gap? Surprisingly, the survey says no. Asked the same question about non-financial metrics, similar percentages of executives said these measures were not effective in terms of supporting the board and senior management. The full results are shown in the accompanying table:

15. Are there any areas in which you feel your company's senior management needs better quality information than it now receives?

Select all areas where better information is needed.

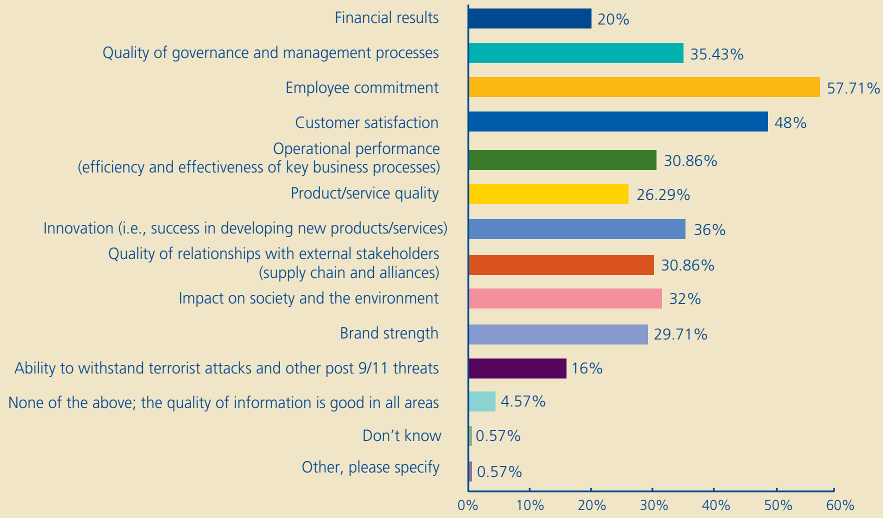
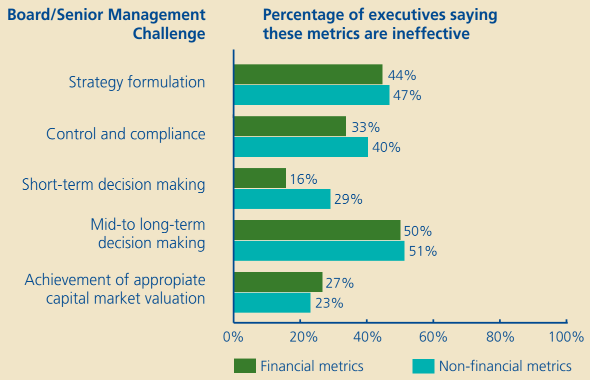


Table B

The metrics reviewed by board/senior management need to be more helpful in addressing board/senior management challenges.



Lack of confidence in metrics

It is noteworthy that across a broad range of important issues, a significant percentage of executives express little confidence in the ability of their performance metrics to inform them about their companies' health and aid decision-making by senior managers.

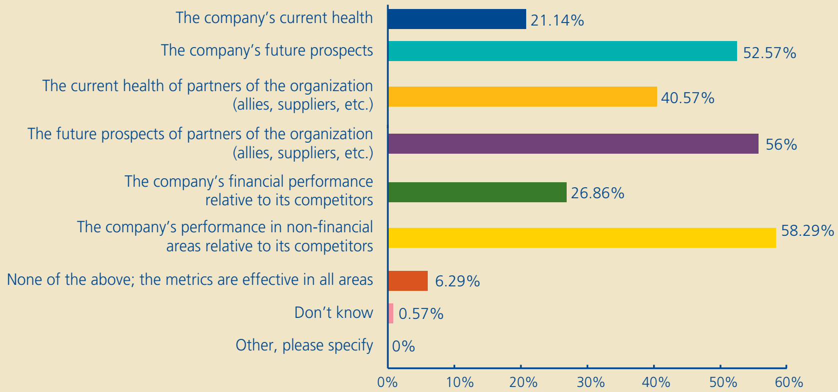
For example, 58 percent say that their senior management and board have no accurate or reliable means of benchmarking non-financial performance against competitors. Neither these executives' companies' financial nor their non-financial performance metrics (nor the two in tandem), are proving effective.

Similarly, 56 percent say that the combined strength of their company's financial and non-financial performance metrics fails to inform and aid the board and senior management in terms of the future prospects of the company's partners. Meanwhile, 41 percent say their metrics are not effective at conveying even the current health of the company's partners.

Perhaps most startling of all, 53 percent say that even when combined, their financial and non-financial performance metrics are not effective at providing the board and senior management with insight relating to their own company's future prospects. Twenty-one percent say their performance metrics are not effective even when providing information to the board and senior management relating to the company's own current health.

17. Do you feel your company's financial and non-financial performance metrics are not effective in providing an accurate and reliable indication to your board and senior management in any of the following areas?

Select all areas where performance metrics are not effective.



Redefining performance measurement and governance: The way forward

The research presented so far might be summarized in three observations:

(1) Executives perceive the growing importance of non-financial performance metrics.

(2) Executives see a gap between their current needs and their capabilities related to non-financial metrics.

(3) Executives see room for improvement in both their non-financial and, to a lesser extent, their financial reporting performance metric programs.

This final section examines some of the reasons for this gap in capabilities, then provides evidence from both the survey and interviews to chart a way forward.

What are the barriers?
There are numerous reasons why companies have been unable to accomplish more in terms of supplying their boards with better non-financial performance measures. According to the survey, the most obvious of these include:

- *Undeveloped tools.*
  Fifty-five percent of respondents say that the tools for analyzing non-financial measures at their companies are not as developed as their financial counterparts.

- *Skepticism.*
  Forty-eight percent of respondents say that people in their companies are skeptical that non-financial metrics directly affect the health of their companies.

- *Accountability.*
  Forty-four percent of executives in the survey say that establishing clear accountability for non-financial performance metrics is difficult.

- *Lack of familiarity.*
  Forty-one percent say management is too unfamiliar with non-financial measures; and an equal percentage of respondents say the same of board members.

- *Lack of benchmarking data.*
  Twenty-one percent say their use of non-financial performance metrics is inhibited by a lack of comparable data from competitors.

- *Time constraints.*
  Nineteen percent of executives say that senior management and the board lack the time needed to feel comfortable using a new set of metrics.

- *Competitive concerns.*
  Six percent of respondents say that they worry that competitors might gain valuable intelligence from non-financial performance metrics.

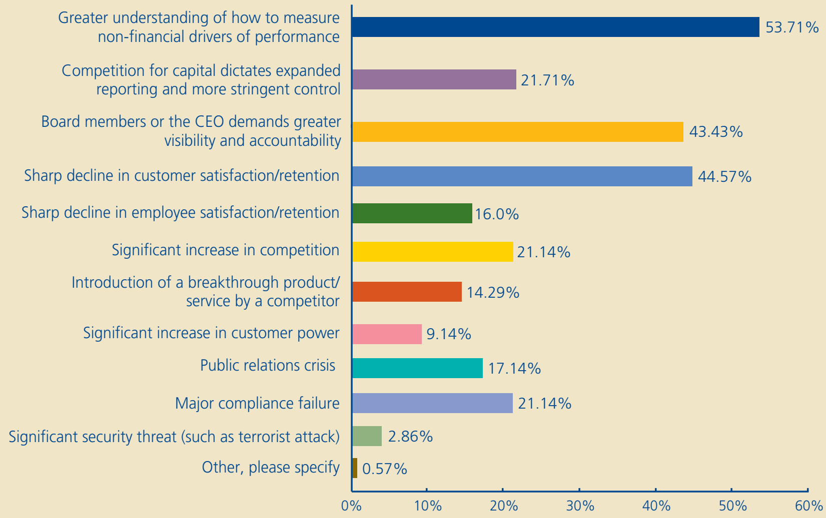
As daunting as the above list may seem, executives were also asked what might spur their own organizations into reassessing how they measure and monitor performance. Ironically, the most frequently cited trigger, noted on 54 percent of respondents' lists, is the achievement of a greater understanding of how to measure non-financial drivers of performance. In other words, if companies knew better how to measure non-financial indicators, they would focus more on them. But they would have to focus more attention on them if measurements were to improve.

The difficulty in developing metrics, says Standard Chartered Bank's Ms. Whitaker, is not a good enough reason to do nothing at all. "We often hear people saying they won't share their human resources data for competitive reasons," she explains. "But what I suspect is that this is just an excuse. The truth is, the company probably doesn't have the data or doesn't know how to track it, and if I were on the board, that wouldn't sit well."

Other events that might spur a closer look at current reporting and performance frameworks include a sharp decline in customer satisfaction or retention (45 percent), as well as board members or the CEO demanding greater visibility and accountability (43 percent). Final items on the list of "events" that might prompt action include: the competition for capital dictating expanded reporting and more stringent control (22 percent); a significant increase in competition (21 percent); a major compliance failure (21 percent); or a sharp decline in employee satisfaction/retention (16 percent).

24. Which triggers are most likely to spur your organization to reassess how it measures and monitors performance?

Select up to three triggers.



But practices are improving

Regardless of the barriers and of the circumstances under which companies believe they might take action, changes are being felt.

Many of the interviewees for the report say that their companies are making great strides in learning how to derive value from non-financial performance metrics.

Maybe these represent situations where boards and management teams are obtaining improved information relating to the various non-financial drivers of success identified by the survey.

For example, Ashland's Mr. Quin says that his company is learning that by managing customer satisfaction, his company can achieve stronger revenues and profits. But the challenge was one of defining an appropriate index. As Mr. Quin explains, "Everyone talks about how customers feel, but what you need is a way to measure that in a consistent and meaningful way."

Consequently, his company has devised what he calls the OTAC index. "That stands for on-time, accurate, and complete—which we've found to be an excellent proxy for customer satisfaction in our distribution business." By managing OTAC, he explains, "we have an idea of how we're doing with our customers, and that will translate into financial results down the road."

Similarly, consider the importance placed on non-financial metrics at South Africa's largest consumer retailer, Edcon. About six years ago, explains Group HR Director Urin Ferndale, "we were experiencing financial distress." Other executives might have focused on cutting costs, says Mr. Ferndale. But "our CEO decided that instead we were going to grow the business out of trouble—and he believed the only way to do that would be to renew our focus on our people."

So immediately, "twenty percent of the stated performance goals of every single supervisor became people-oriented," says Mr. Ferndale. Then, even as the company's financial performance began to improve,

When it comes to fostering accountability for customer satisfaction, the survey detected significant discrepancies in perceptions between executive directors, non-executive directors and senior managers. Fifty-one percent of non-executive directors say their companies reward managers for good performance in this area. However, the figure falls to 37 percent among executive directors and then to 22 percent among senior managers.

the focus on people management continued to increase to the point where today, "around 50 percent of performance goals are people-focused."

What the company now knows is that in its industry, there is a high correlation between revenue growth and employee engagement measures. "As we increased the people component in the evaluations," says Mr. Ferndale, "and as employee engagement improves, we've grown sales and profitability." For example, in 2000, the company's staff turnover exceeded 30 percent and its ROE was less than 6 percent. Today, says Mr. Ferndale, "our staff turnover is around 11 percent, and our ROE is over 40 percent."

In addition, not only is the company a recipient of rewards relating to being an "employer of choice"; today, Edcon's board is well-informed on people issues. Mr. Ferndale is in fact a member of the management committee. Ultimately, says Mr. Ferndale, "our company is an example of where a focus on people, on non-financial performance metrics, actually improves our financial performance—and we have the graphs and overlays to prove it."

Non-financial indicators are the responsibility of management

When executives were asked who should monitor the financial results of the company, 80 percent said that the board and management should share responsibility. When they were asked about specific non-financial indicators, however, they said that in most cases monitoring should be done by senior managers, except innovation where more people said that the monitoring should be shared.

Many interviewees add that non-financial measurements are more relevant for individual activities and financial measurements are important for the company as a whole.

Table C
Who should monitor?

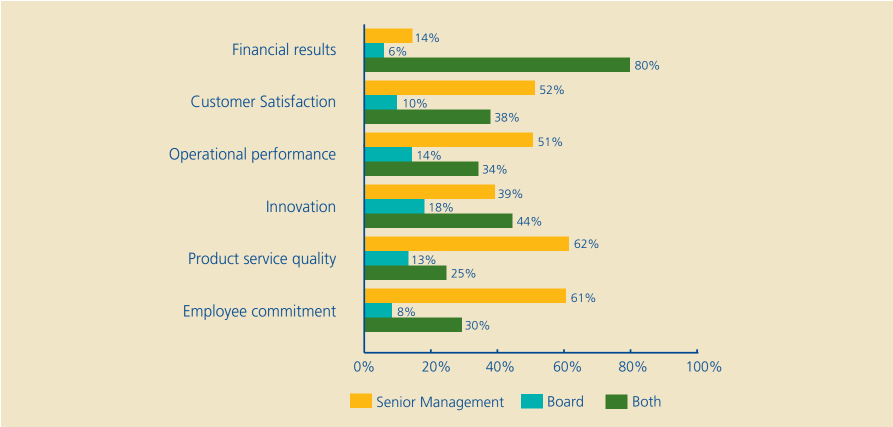
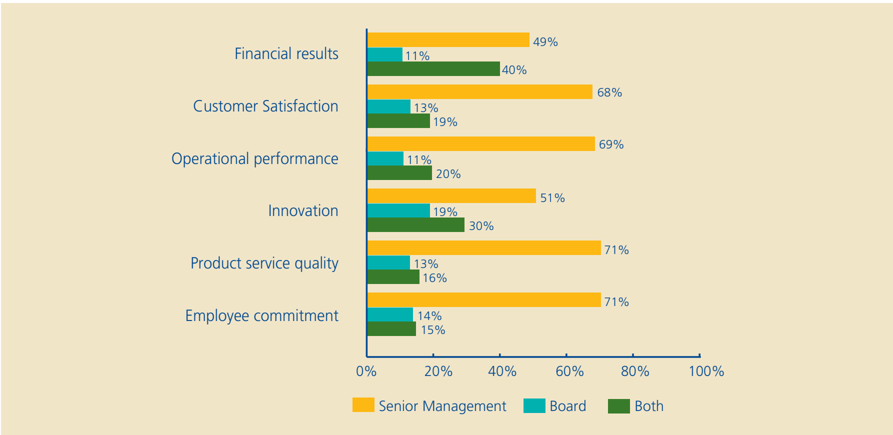


Table D
Who should take primary responsibility?



Consider the example of Administaff, a provider of personnel management services, based in Houston, Texas. According to Administaff Chairman and CEO Paul J. Sarvadi, "Depending on where you fit in the organization, that will determine how much of your performance incentives are financially or non-financially oriented." For example, "If you're near the executive area, more of your compensation is based on total financial results and not tasks," he explains. But the further down you go into the organization, "the higher the percentage of your income is determined by non-financial metrics."

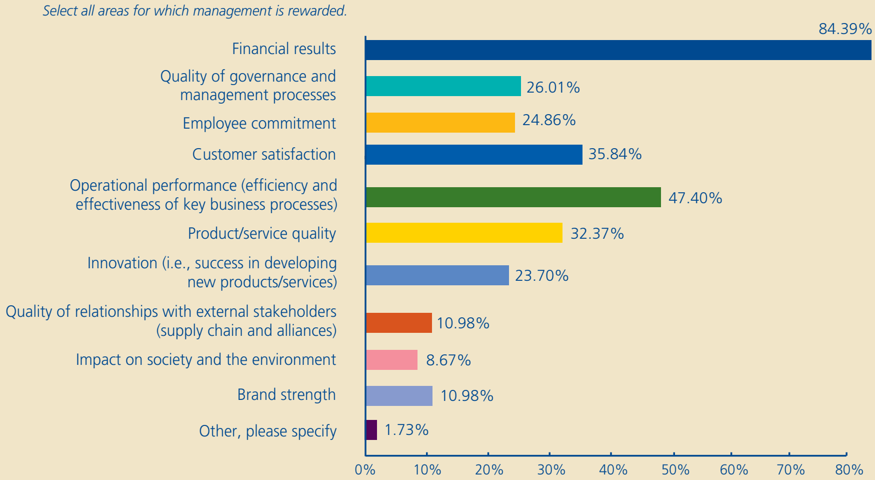
Ashland's Mr. Quin concurs. "If you look at our proxy, you'll see how the top five executives are compensated, and it's all about financial metrics: ROI, sales, profit growth." But moving deeper into the organization, "you'll see we have hundreds or maybe even over 1,000 people who are involved in some form of incentive compensation." Here, says Mr. Quin, "the metrics reflect objectives for individuals." While many of the metrics are still financial in nature, "the further down you go, the more importance you'll see attached to the non-financial performance."

A few details of current practice

What a company measures and rewards drives the performance it will obtain. The following tables offer a view of the most commonly tracked areas of incentives along with examples of specific metrics.

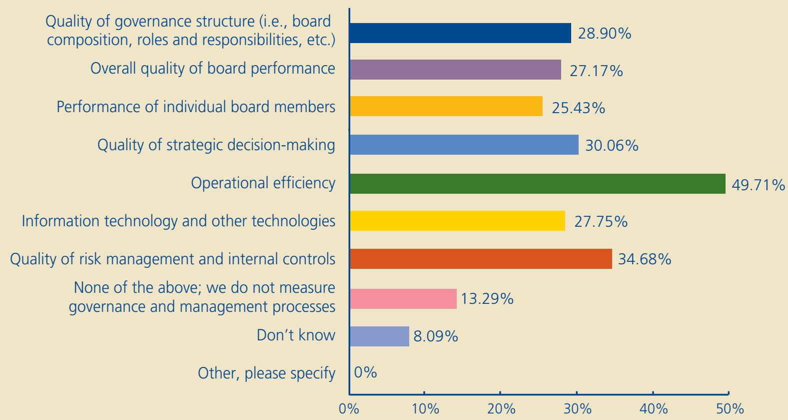
20. In which of the following areas of performance does your board hold management accountable by rewarding them for good performance?

Select all areas for which management is rewarded.



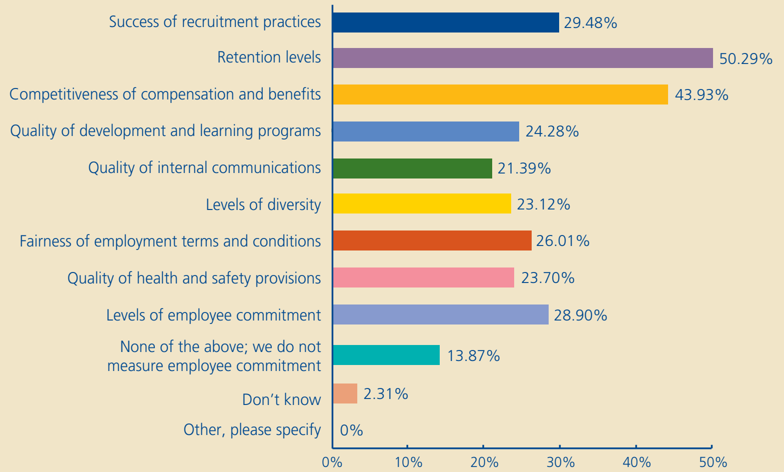
21. In which of the following areas of governance and management processes does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.



22. In which of the following areas of employee commitment does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.



23. In which of the following areas of customer satisfaction does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.

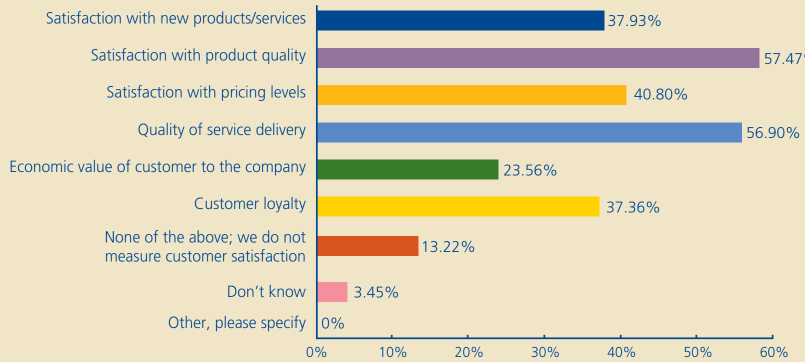
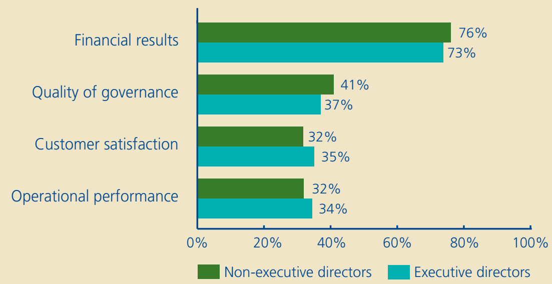


Table E

In your role, select the three areas commanding the greatest share of your attention.



The way forward: The potential value and role of non-financial metrics

A key theme of this report is that a growing number of executives suspect that there may be undiscovered value in non-financial metrics. For example, one potential role for non-financial metrics is the advancement of predictive capabilities.

Consider the following. Among survey respondents, 37 percent say their company's performance is determined more by intangible assets/capabilities than by hard assets. For example, employee engagement, customer loyalty or innovative capabilities (or some combination) might be the principal drivers of a company's value.

Similarly, 54 percent say forward-looking information is of greater value to management and the board than historical information. Again, what if a decline in customer loyalty precedes financial distress by many months? Or alternatively, what if improvements in innovation measures could be shown to be highly correlated with medium-term financial gains?

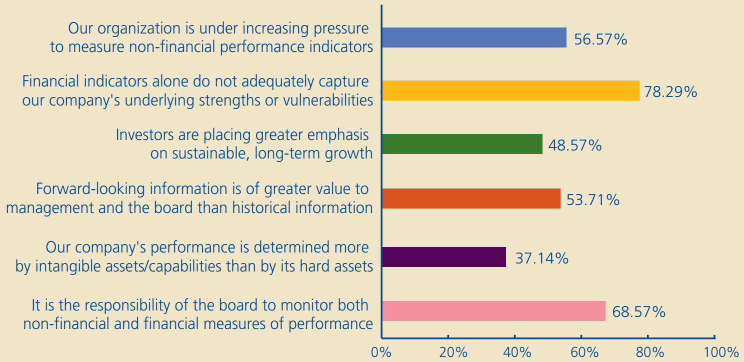
As companies gain experience with non-financial metrics, they might discover a wide range of predictive, forward-looking managerial tools. But of even greater value, says Ms. Whitaker, are non-financial metrics which are not only predictive, but actionable.

"We've done considerable research, and our data tells us that profit margin and customer satisfaction are intimately related with employee engagement," explains Ms. Whitaker. "So when we see highly engaged teams, we know they're going to be high-performing on a range of business measures, including revenue and profit margin growth, productivity and employee retention."

Consequently, says Ms. Whitaker, the company can translate the predictive properties of employee engagement metrics into actions that drive profits. "We can see where there could be trouble," says Ms. Whitaker, but even more importantly, "we can be proactive. We know that managers have the biggest impact on team engagement. So we've studied what our best managers do that sets them apart and then try to repeat that throughout the bank through selection and development." So non-financial metrics, concludes Ms. Whitaker, "are a very powerful tool."

7. With which of the following statements regarding non-financial performance indicators do you agree?

Select all statements with which you agree.



> Though numerous interviewees relate successes in this area, only 14 percent of non-executive directors and 27 percent of executive directors cite employee commitment as one of the "top three" priorities.

Another example of fresh thinking in the use of non-financial performance metrics comes from Administaff. According to Administaff Chairman and CEO Paul J. Sarvadi, financial metrics have their place. But financial results, he insists, are simply the means of keeping score of business results. "To manage financial results, you first need to identify, understand and manage the underlying drivers of financial performance," says Mr. Sarvadi.

For example, "one of the things investors want to know about is revenue growth," says Mr. Sarvadi. "But if you back up from the revenue, what drives that number is our sales and our retention of customers." So the "bow of the ship" says Mr. Sarvadi, "is our service satisfaction numbers" alongside "the number of trained and capable sales representatives." Those two pieces of information, Mr. Sarvadi insists, "are the precursors to what's ahead in financial performance." (Not surprisingly, says Mr. Sarvadi, "customer satisfaction is becoming a more important piece in incentive compensation.")

A word of caution
A number of interviewees doubted there was a magic bullet for corporate insight. One such is Dow's Mr. Reinhard. While the executive understands that non-financial performance metrics have their place, in general he offers caution.

"Non-financial metrics can be important or even very important depending on what type of industry and what type of business you are in." For example, at Dow "we were using global surveys of employee engagement, motivation and performance for over 10 years." These surveys, says Mr. Reinhard, "were very useful and they helped us to improve our performance." However, "I don't believe this information was of much use to shareholders and it certainly was nothing I wanted to share with our competitors."

Similarly, says Mr. Reinhard, "you can't go to shareholders and say, here, this is a new business strategy and it's based completely on non-financial performance metrics. Your shareholders need to see financial results along the way to the achievement of a long-term business strategy. So sooner or later, your non-financial ideas have to translate into tangible, financial returns."

The best approach: use both
In the end, Mr. Reinhard maintains, what's called for is an analysis of what "works." In many cases, companies will indeed find there are uses for non-financial metrics. However, says Mr. Reinhard, "I don't believe they should ever completely take over. They can be part of a balanced strategy; they are something you can maybe use to steer the business; but they will not and should not completely replace financial performance."

In this regard, Ashland's Mr. Quin—along with nearly all of our interviewees—agrees:

"Financial performance metrics are the ultimate results for the business. Non-financial metrics can give you insight, an idea of what's driving the results. And there's no question, this kind of insight is hard to develop.

"But the real trick here from a governance point of view is that you need a blend of both. As a director you need to know both financial and non-financial metrics to get a true picture of what's happening in the company and the marketplace. And if your operations aren't giving you solid non-financial reporting, if they're not giving you an idea of what drives the results, then you need to know why—you can't operate in the dark."

Conclusions

As with the 2004 study, this latest research again reveals a critical fault line between rhetoric and reality in the boardrooms of some of the world's leading companies. Many boards and executives are still in the dark about the health of their businesses. Non-financial factors are widely regarded as extremely important drivers of success for a company, yet in most cases they receive considerably less attention than financial data from the board and senior managers.

The reasons for such a mismatch are easy enough to list. Reliable non-financial performance metrics—reliable in the sense that they absolutely correlate to financial performance—are difficult to discern. Consistently tracking such "soft" issues as employee engagement, innovation or customer satisfaction is viewed as more art than science. Financial metrics seem more solid and familiar. Naturally, there is resistance.

But the signs of change first detected in the 2004 study are still in evidence today. Companies such as Harrah's Entertainment, Standard Chartered Bank, Edcon, or Royal Bank of Canada are scoring visible successes by more closely tracking and managing non-financial performance metrics. Many more companies are including non-financial data in their annual reports or their shareholder briefings. Compensation structures continue to evolve to include non-financial targets.

So certainly, board members are becoming increasingly aware of the potential value of non-financial metrics. Many are becoming more vocal; many are applying lessons learned.

Still, the statistical findings of this report raise some red flags. Boards and management teams by their own admission see that the information they need is not the information they are receiving. So as this latest report on the state of non-financial reporting reveals, there is much more work to be done.

Interviewees

1. **Martin G. Carver**
Chairman, President and CEO
Bandag Incorporated

2. **Urin Ferndale**
Group HR Director and Member of the Board
Edcon

3. **Jay Lorsch**
Director; Chair of the Corporate Governance Committee
CA Inc.
Harvard Business School: Louis E. Kirstein Professor of Human Relations

4. **Elizabeth Martin-Chua**
SVP HR
Philips China

5. **Dr. Walter Massey**
President, Morehouse College
Member of the Board: McDonald's, British Petroleum, Bank of America

6. **David Norton**
SVP Relationship Marketing
Harrah's Entertainment

7. **J. Marvin Quin**
SVP and CFO
Ashland Inc.

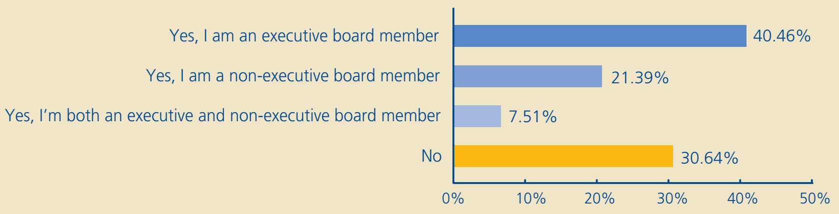
8. **Pedro Reinhard**
Board of Directors: Dow Chemical, Royal Bank of Canada, Colgate-Palmolive, Sigma-Aldrich
EVP and CFO Dow Chemical (retired 2005)

9. **Paul J. Sarvadi**
Chairman and CEO
Administaff

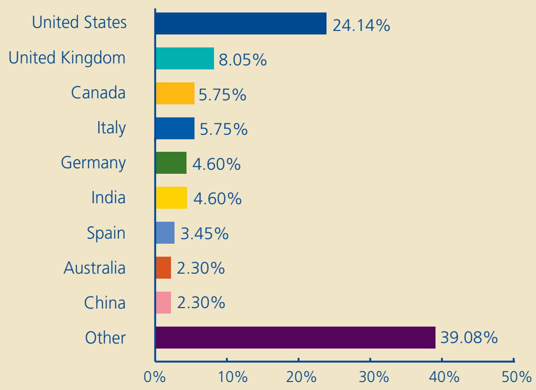
10. **Debbie Whitaker**
Group Head, People Product Management
Standard Chartered Bank

Questionnaire

1. Are you a member of a corporate board?

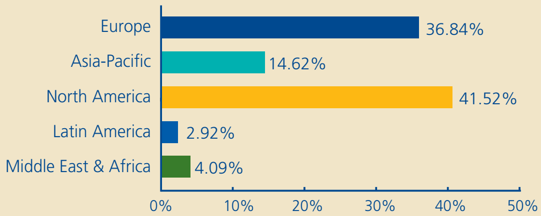


2. In what country are you personally based?

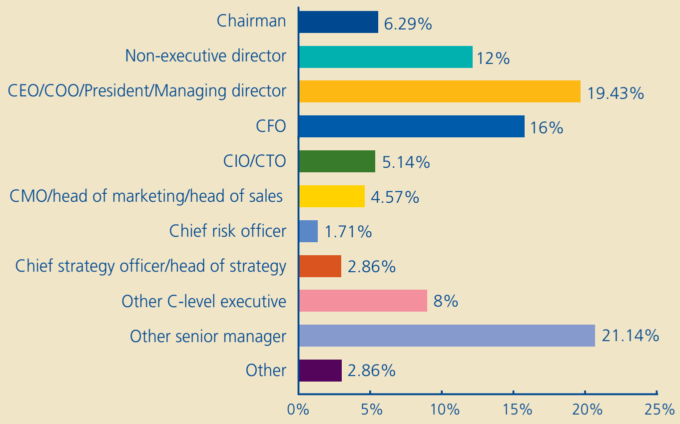


3. Where is your company headquartered?

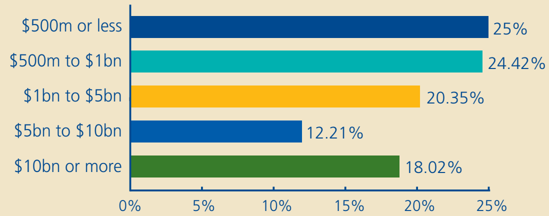
Refer to the company on whose board you sit, if you are a board member.



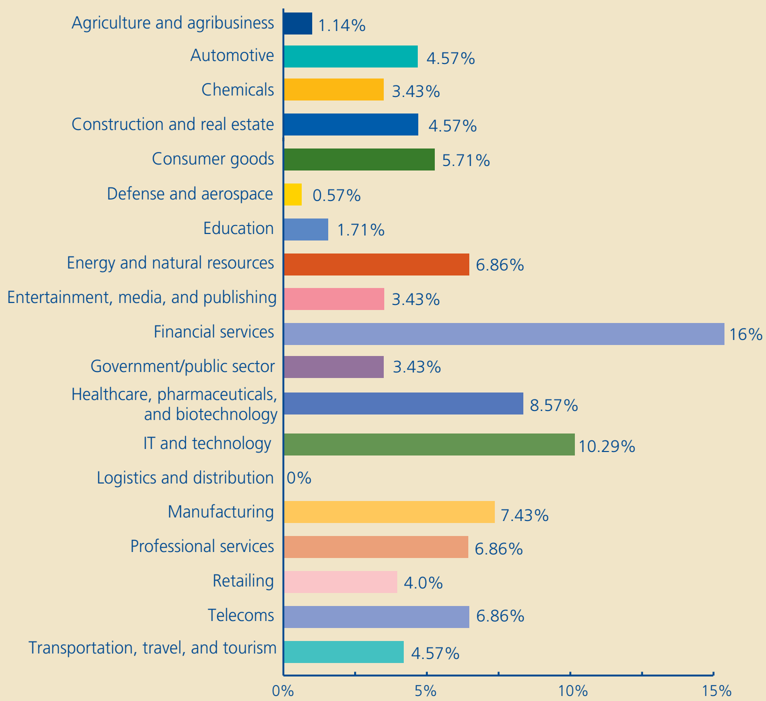
4. What is your title?



5. What are your organization's global annual revenues in US dollars?

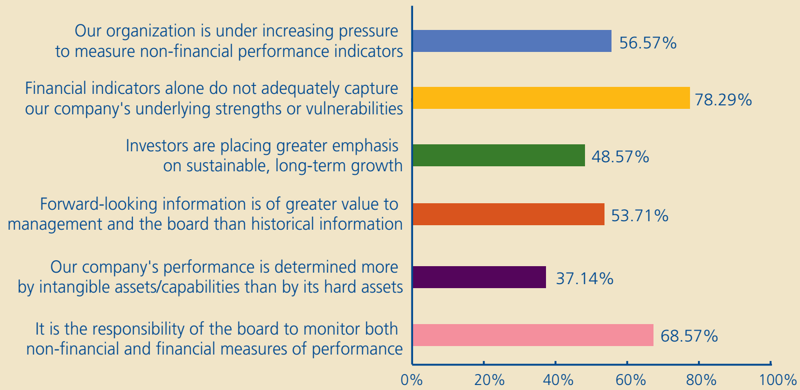


6. What is your primary industry?

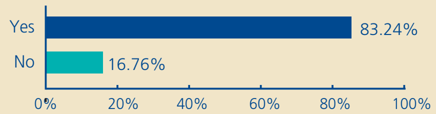


7. With which of the following statements regarding non-financial performance indicators do you agree?

Select all statements with which you agree.

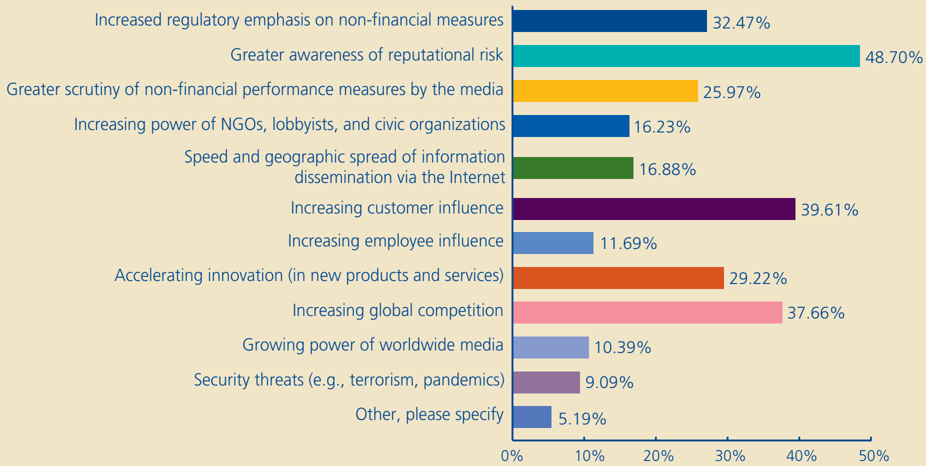


8. Do you believe there is inceasing emphasis in the marketplace on non-financial performance measures?



If yes, what do you think is driving the increased emphasis on non-financial performance measures?

Select the top three drivers.



9. Which of the following areas of corporate performance are the key drivers of success for your organization?

Select the top three drivers.

10. Which areas of corporate performance do you believe your company's senior management should monitor, and which should the board monitor?

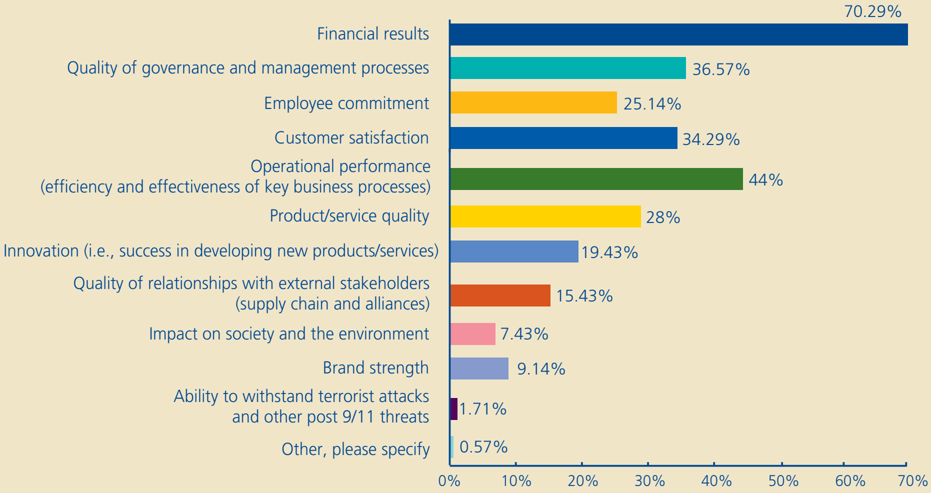
	Senior management should monitor	Board should monitor	Both should monitor
Financial results	14.45%	5.78%	79.77%
Quality of governance and management processes	12.28%	40.35%	47.37%
Employee commitment	61.40%	8.19%	30.41%
Customer satisfaction	52.02%	9.83%	38.15%
Operational performance (efficiency and effectiveness of key business processes)	51.15%	14.37%	34.48%
Product/service quality	61.85%	12.72%	25.43%
Innovation (i.e., success in developing new products/services)	38.60%	17.54%	43.86%
Quality of relationships with external stakeholders (supply chain and alliances)	43.35%	21.97%	34.68%
Impact on society and the environment	15.79%	30.41%	53.80%
Brand strength	28.32%	11.56%	60.12%
Ability to withstand terrorist attacks and other post 9/11 threats	31.76%	17.65%	50.59%

11. Which areas of corporate performance do you believe your company's senior management should take primary responsibility for, and which should the board take primary responsibility for?

	Senior management should take responsibility	Board should take responsibility	Both should take responsibility
Financial results	48.85%	11.49%	39.66%
Quality of governance and management processes	21.97%	49.13%	28.90%
Employee commitment	70.76%	14.04%	15.20%
Customer satisfaction	68.21%	13.29%	18.50%
Operational performance (efficiency and effectiveness of key business processes)	68.97%	10.92%	20.11%
Product/service quality	71.10%	13.29%	15.61%
Innovation (i.e., success in developing new products/services)	51.16%	18.60%	30.23%
Quality of relationships with external stakeholders (supply chain and alliances)	49.43%	21.26%	29.31%
Impact on society and the environment	21.84%	38.51%	39.66%
Brand strength	48.24%	17.06%	34.71%
Ability to withstand terrorist attacks and other post 9/11 threats	39.77%	20.47%	39.77%

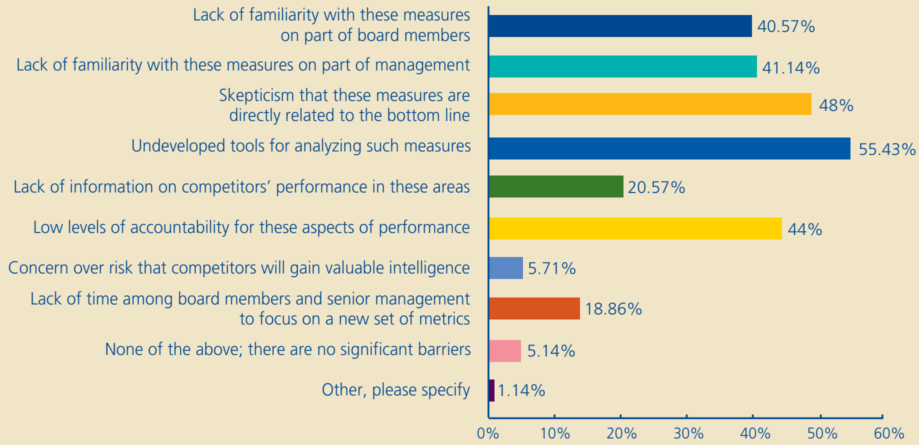
12. In your role, to which of the following areas do you give the greatest attention?

Select the top three areas.



13. What do you think are the main barriers to the effective usage of non-financial performance measures by your organization?

Select the top three barriers.

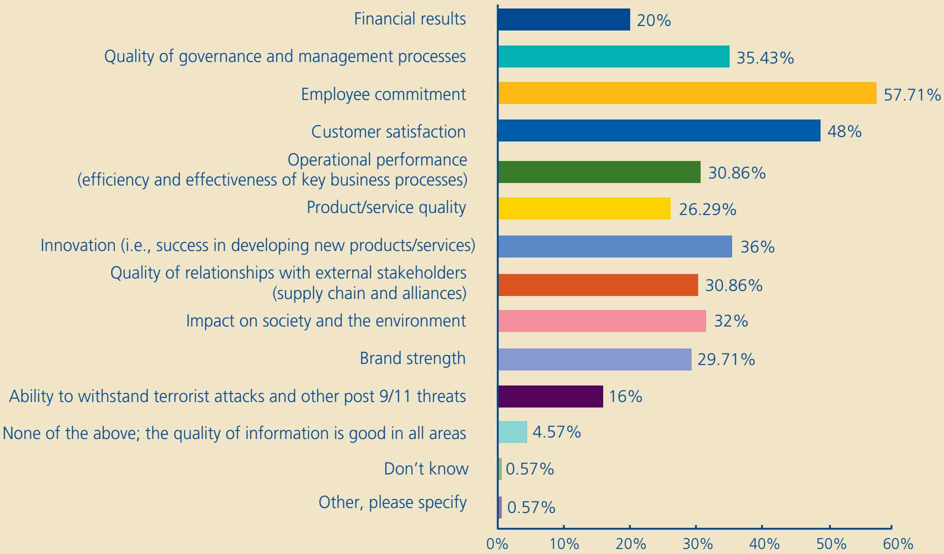


14. How would you rate the quality of information that your board gets in each of the following areas of corporate performance?

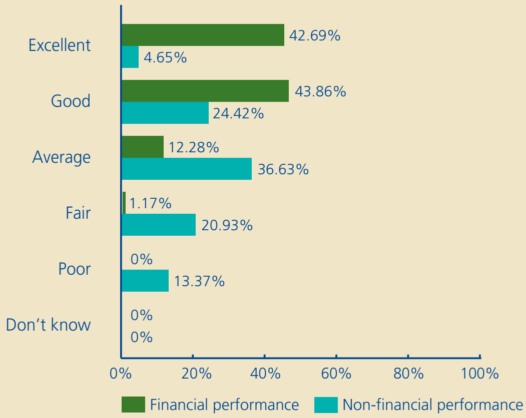
	Excellent	Average	Poor	Don't know
Financial results	67.82%	28.16%	2.30%	1.72%
Quality of governance and management processes	27.75%	50.87%	16.76%	4.62%
Employee commitment	12.14%	49.71%	29.48%	8.67%
Customer satisfaction	23.12%	46.82%	22.54%	7.51%
Operational performance (efficiency and effectiveness of key business processes)	29.89%	49.43%	16.09%	4.60%
Product/service quality	25.86%	54.60%	10.92%	8.62%
Innovation (i.e., success in developing new products/services)	19.19%	48.26%	23.26%	9.30%
Quality of relationships with external stakeholders (supply chain and alliances)	17.92%	52.60%	21.97%	7.51%
Impact on society and the environment	17.24%	44.25%	30.46%	8.05%
Brand strength	26.44%	50.00%	16.67%	6.90%
Ability to withstand terrorist attacks and other post 9/11 threats	16.18%	35.84%	21.97%	26.01%

15. Are there any areas in which you feel your company's senior management needs better quality information than it now receives?

Select all areas where better information is needed.

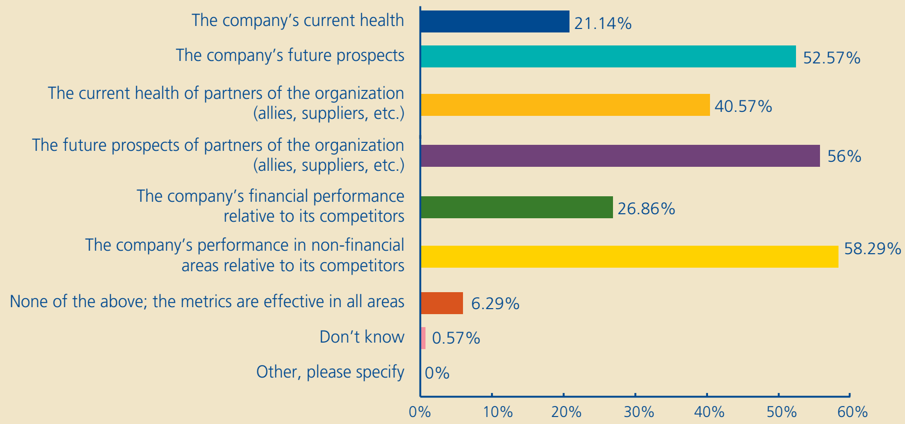


16. How would you rate your organization's record of measuring and monitoring financial and non-financial aspects of performance?



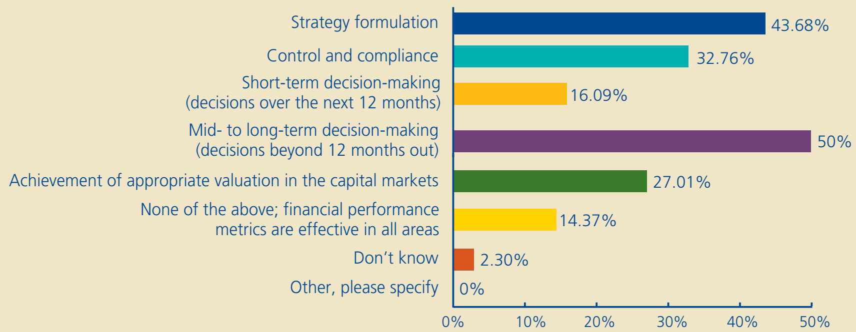
17. Do you feel your company's financial and non-financial performance metrics are not effective in providing an accurate and reliable indication to your board and senior management in any of the following areas?

Select all areas where performance metrics are not effective.



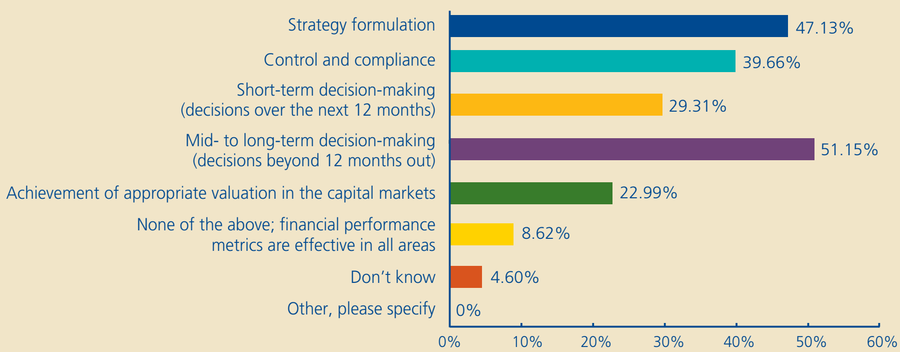
18. Are there any business objectives you feel your company's financial performance metrics do not effectively support the board and senior management in accomplishing?

Select all objectives for which financial performance metrics are not effective.



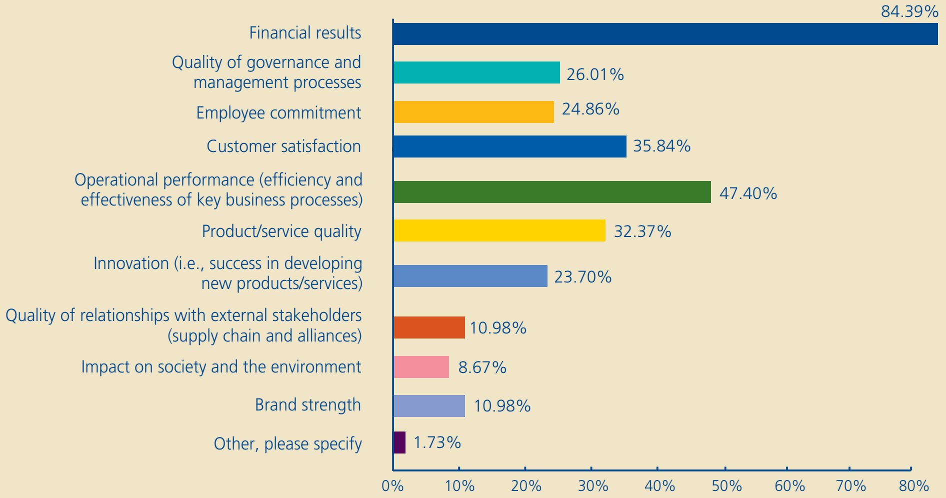
19. Are there any business objectives you feel your company's non-financial performance metrics do not effectively support the board and senior management in accomplishing?

Select all objectives for which non-financial performance metrics are not effective.



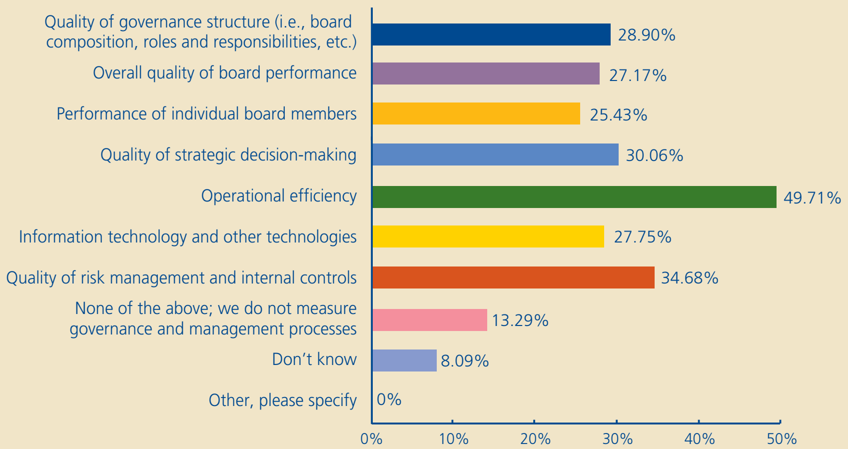
20. In which of the following areas of performance does your board hold management accountable by rewarding them for good performance?

Select all areas for which management is rewarded.



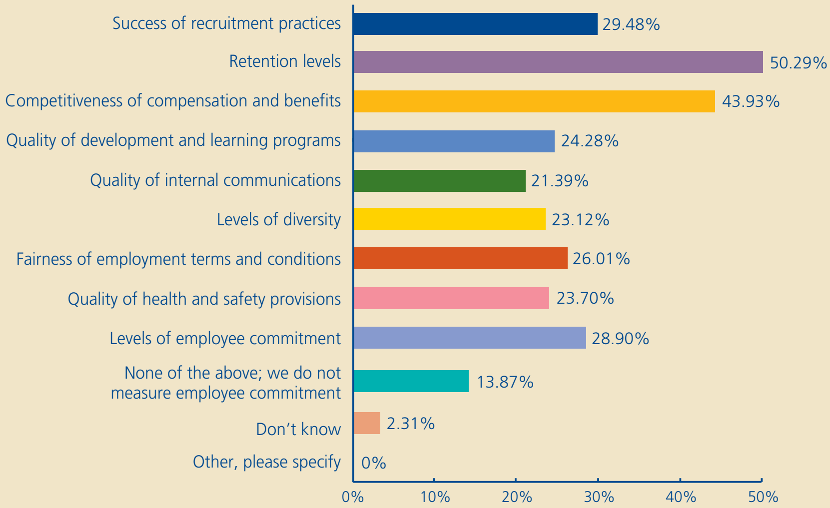
21. In which of the following areas of governance and management processes does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.



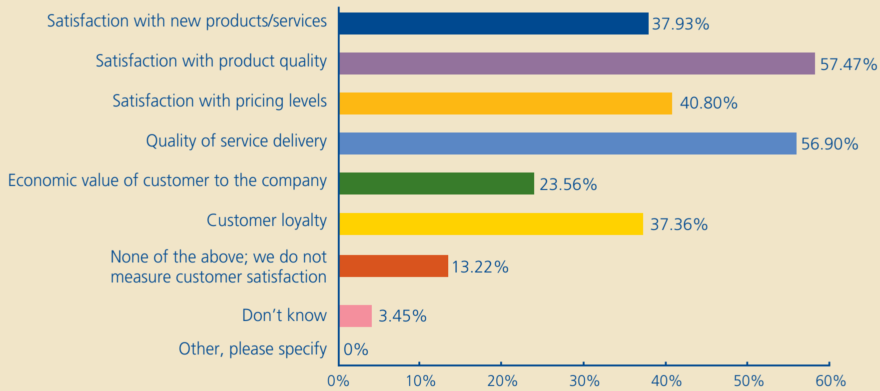
22. In which of the following areas of employee commitment does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.



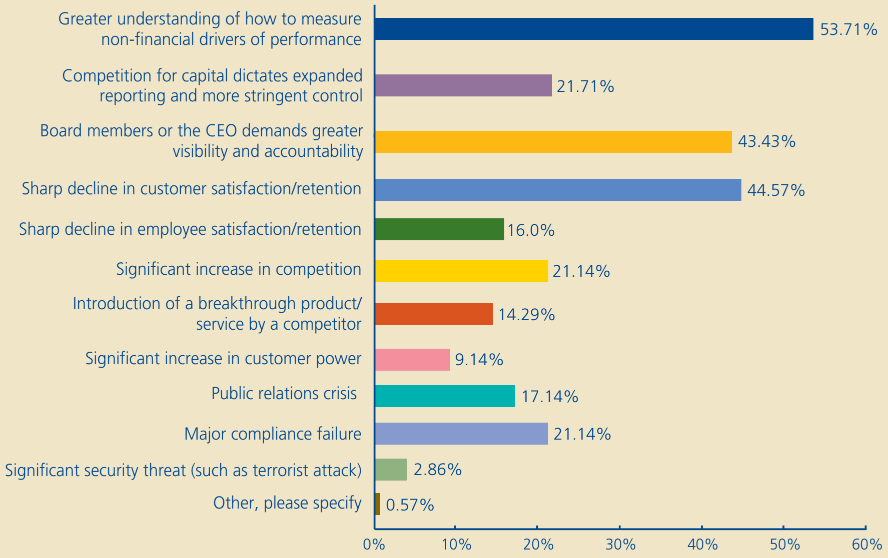
23. In which of the following areas of customer satisfaction does your board or senior management use identifiable performance metrics to run the company?

Select all that apply.



24. Which triggers are most likely to spur your organization to reassess how it measures and monitors performance?

Select up to three triggers.



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