

## CFO Insights

### Harnessing *The Three Rules*

For decades, management studies have sought to identify the qualities that distinguish the truly great companies from the rest. Such studies often have focused on what actions companies and their leaders have taken to achieve high performance—actions that can't necessarily be replicated by other organizations for various reasons.

Perhaps a more useful guide is how exceptional companies think and how the decision-making rules they seemed to use propelled the truly great performers into long-term success. In their new book, *The Three Rules: How Exceptional Companies Think* (Portfolio/Penguin, May 2013), authors Michael E. Raynor, director, Deloitte Services LP, and author of *The Strategy Paradox*, and Mumtaz Ahmed, chief strategy officer at Deloitte LLP, identify three rules that capture how high-performing outliers deliver superior performance over the long run, despite facing the same constraints as their competitors:

**Rule 1: Better before cheaper.** Compete on differentiators other than price.

**Rule 2: Revenue before cost.** Drive superior profitability with emphasis on higher prices and higher volumes, not lower cost.

**Rule 3: There are no other rules.** Change anything/everything in order to abide by the first two rules.

According to the authors, the three rules can guide business leaders in setting their agendas and making critical decisions despite the ambiguity and uncertainty in today's environment. Their research also provides the hard evidence useful to leaders as well as detailed examples, including Merck in the pharmaceutical industry, Abercrombie & Fitch in retail, and Maytag in appliances, as well as smaller, less-headline-grabbing companies such as grocer Weis Markets and trucking company Heartland Express. In this issue of *CFO Insights*, we'll discuss the findings from the research and offer key takeaways for CFOs and their finance teams.

#### Why there are no other rules

The work in *The Three Rules* is based on research gathered from more than 25,000 U.S.-based companies in hundreds of industries over a 45-year period, and the book outlines what those findings can mean for companies looking to improve their performance trajectory.

Specifically, Raynor and Ahmed analyzed more than 300,000 company-year observations from 1966 to 2010 to identify a population of 344 exceptional companies. And from this population, they selected a representative sample of trios; three companies from each of nine industries that represent what they term the "Miracle Worker," the "Long Runner," and the "Average Joe," respectively (see Table 1: The Nine Trios). Then, by comparing the very best (the Miracle Worker) with the very good (the Long Runner), and both with the merely average (the Average Joe), they built their case for two different types of exceptionalism. First, what does it take to pull away from the pack; that is, how do Miracle Workers and Long Runners separate themselves from Average Joes? Second, how do Miracle Workers pull away from Long Runners?



Raynor and Ahmed used return on assets (ROA) as their benchmark, noting that it reflects to a significant extent what management has done to affect performance. Other measures, they argue, may be affected by factors outside managers' control. For example, total shareholder return and share price are subject to the vagaries of investors' expectations. Variations on ROA, such as return on equity, return on capital employed, and return on invested capital, can also work, but in the researchers' estimation, ROA is more likely to capture the outcome that is directly related to management behavior and reflects the outcomes of strategy execution. Moreover, since ROA can be broken down into its constituent elements, that is, gross margin, asset turnover, and so on, it can connect specific behaviors to specific performance outcomes.

Such a capability proved invaluable when the researchers initially looked for patterns of behavior that connected specific activities, such as innovation and growth and R&D, to superior performance—and didn't find any. They began to extract order from the chaos, however, by shifting the focus from how companies behaved to the decision-making rules implicit in their choices. Take deals, for example. The key questions were, "Do great companies do more deals or fewer deals?" and "Do they do different types of deals?" As it turned out, similar patterns of deal activity were common to the highest-achieving companies as well as to the ordinary performers (that is, both Miracle Workers and Average Joes did multiple deals in one sector and very few in another). It was only by linking their patterns of dealmaking to a higher purpose—specifically, better before cheaper and revenue before cost—that the consistency of performance made sense. Moreover, the more persistently the rules were pursued, the better the odds of beating the competition and becoming truly exceptional.

In fact, the results showed that the companies in the nine trios made systematically different choices across a wide range of issues. The Miracle Workers consistently put better before cheaper and revenue before cost, while the Long Runners did so to a somewhat lesser extent. Why the companies made certain choices at that time the researchers couldn't say. But by examining the choices that made a difference for success, they inferred the kinds of decision rules consistent with those choices, namely, better before cheaper and revenue before cost. Moreover, when considering all the other activities that companies could do to affect performance—outsource, diversify geographically, divest, and so on—they found such choices made sense only when viewed through the lens of the first two rules. Hence, the third rule: There are no other rules.

### Implications for finance

All three of the rules have implications for finance and for CFOs. For example:

**1. Financial management.** Rule 2, which is about putting revenue before cost, is obviously very strongly associated with financial management. But following this rule requires not just a line-item focus, but opening the aperture to a more expansive view of the income statement and balance sheet and the decisions that shape them. In fact, it's important to think of the rule not in a horizontal line-item sense, but from a vertical perspective in terms of integrated choices, because capturing value depends on it. It means asking questions such as, "Where should a CFO cut costs and where should he or she manage costs in a way that allows the company to do what it needs to do in the market in terms of positioning, pricing, and so on?" Moreover, it's important for CFOs to understand whether or not what the company is spending serves the purpose of a differentiated positioning, which can allow it to command premium prices and capture share and volume that couldn't be achieved otherwise. Taking that integrated view is critical, and that's where CFOs can help enormously with Rule 2, given Rule 1—better before cheaper—is already in operation.

2. **Performance metrics.** Taking a vertical view, focusing on capturing value, also has implications for what companies measure. If you consider what CFOs might benchmark, such as earnings per share or return on investment, it could be easy to fall into the trap of looking at things they know well and succumbing to metric myopia. But keep in mind that companies don't compete based on industry averages. Rather, they compete with specific alternatives. Customers don't decide whether they're going to buy the industry-average product; they decide whether they're going to buy your product or your competitor's product. That's the choice they face. And so when CFOs and other executives are sizing up their company's relative performance, they need to look beyond the industry averages to how the choices they are making will lead to long-term superior profitability.
3. **Dealmaking.** M&A to improve positioning or to achieve scale makes sense. M&A in desperation to change a downward performance trajectory doesn't work. In fact, the research shows that some companies misinterpret their standing and how their position in an industry has changed, and then do a deal as a desperate remedial measure rather than a deliberate design. Others do M&A with the explicit purpose of climbing up the food chain to create greater value for customers and greater differentiation for themselves. Basically, M&A, when done for the right reasons—which are about getting better before cheaper and about emphasizing revenue before cost—can be effective. In fact, while a merger designed to reduce a company's cost structure is not necessarily a bad idea, it is unlikely to be a material contributor to superior long-term profitability.
4. **Decision making.** The personal attributes of decision making were not part of the research—beyond deciding to follow the rules. In fact, what is described are decision-making rules that any CFO, or any executive for that matter, can adopt regardless of what his or her personal leadership qualities might be. The common thread among the exceptional companies, however, was that their leaders' decisions were guided by a

desire to create value for customers and a commitment to do whatever it takes to push the top line based on its differentiated position, whether that be premium pricing, higher volume, etc. In the process—and sometimes unknowingly—these executives created value for shareholders and delivered exceptional long-term profitability.

#### Where to start

For CFOs, applying the three rules starts with a diagnostic that shows how their companies stack up over time against the companies they consider their most important competitors. Once that diagnostic is in place, executives can then look at allocation of effort: Where is the business spending most of its energy and money? Where is the organization focused? How are incentive structures aligned? Is management consistently pointing the company toward improving its differentiation and improving its price and volume advantages, or is too much time spent worrying about price competitiveness and finding ways to cut costs?

If a company finds it's spending most of its time, energy, and money at the wrong end of each of the first two rules, the next step is to make the sorts of improvements that build superior long-term profitability. Ultimately, for any company, that starts with understanding its positioning, its performance, and how it compares with the best—and then applying the three rules to move it closer to the truly exceptional organizations.



**Table 1. The Nine Trios**

In *The Three Rules*, high-performing companies were grouped by industry according to their relative ranking. Each set of three industry groups contains a Miracle Worker, the highest-performing companies according to the research criteria; a Long Runner, also a high performer but not at the top level; and an Average Joe, with the lowest relative rating.

Industry	Miracle Worker	Long Runner	Average Joe
Semiconductors	Linear Technology	Micropac Industries	International Rectifier
Medical devices	Medtronic	Stryker	Invacare
Electrical wiring	Thomas & Betts	Hubbell	Emrise
Clothing	Abercrombie & Fitch	Finish Line	Syms
Confectionary	Wm. Wrigley Jr. Company	Tootsie Roll Industries	Rocky Mountain Chocolate Factory
Groceries	Weis Markets	Publix Super Markets	Whole Foods Market
Pharmaceuticals	Merck & Co.	Eli Lilly & Co.	KV Pharmaceutical
Trucking	Heartland Express	Werner Enterprises	P.A.M. Transportation Services
Appliances	Maytag	HMI Industries	Whirlpool

Source: Compustat; authors' analysis

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