How “The Three Rules” guide strategy and investment decisions at Deloitte Consulting LLP

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Several years ago, two of my Deloitte colleagues, Michael Raynor and Mumtaz Ahmed, set out to answer the question, “Why do some companies achieve long-term exceptional performance while so many others are not able to sustain the same kind of success?” They began a large-scale research project that identified patterns in the way exceptional companies think. Their key findings were summarized in their 2013 book *The Three Rules*.[1]

The rules are:

- **Rule No. 1: Better before cheaper.** When it comes to how you differentiate yourself from the competition, seek out a position based on qualities other than price. Price-based competition can work in the short-term, but only rarely does it drive sustained and exceptional performance.
- **Rule No. 2: Revenue before cost.** Driving superior performance means having some combination of higher revenue and lower costs than your competition. The advantages of higher revenue tend to be more valuable and durable than the advantages of lower cost. Use your differentiated position to charge higher prices or appeal to more customers. Do not try to cost cut your way to greatness. Just like price-based competition, cost advantages can be effective, but only infrequently.

Jim Moffatt, Deloitte CEO

- **Rule No. 3: There are no other rules.** Whatever competitive or environmental changes or challenges you might face, do not give up on the first two rules. Everything else is up for grabs. Change whatever you must about your business – your markets, your technologies, your people – but no matter what, stick with better before cheaper and revenue before cost.

The conclusions emerged from a database of over 25,000 companies from hundreds of industries operating during a 45-year span. From the data, Raynor and Ahmed uncovered companies that qualified as statistically “exceptional,” a group that the authors reduced to just 344 companies after their further analysis separated the truly skillful from the merely lucky. The study identified the three principles as central to the decision process executives and leaders of exceptional companies practiced to shape their thinking about a range of difficult issues – when to invest, when to step

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back from competition, when to focus on cost-cutting and what it means to emphasize growth.

Practicing what we preach

Since the release of the research, we’ve been asked numerous times how we use the three rules at our organization. After all, now that we know how exceptional companies think, we had to force ourselves to ask the question, “Does Deloitte think like an exceptional company?”

As an organization, Deloitte went from being ranked seventh of the eight major audit and advisory firms to first of the four that survived the last two decades of industry churn. Deloitte Consulting LLP has played a significant role in this rise.[2]

Our growth occurred during a time of dramatic economic and structural change, notably the period after the passage of the Sarbanes-Oxley reforms. Of the largest organizations specializing in accounting and advisory services, Deloitte was the only one that chose to retain and continue developing its consulting business. That decision proved critical, but it hardly secured our future success.

Since that time, the management consulting industry has attracted competitive entrants.[3] Prospective clients have more choices than ever before – major strategy-based firms, low-cost providers of technical services, specialty and boutique firms. Deloitte operates as a full-service organization handling everything from strategy all the way through execution. This competition has created new pressures: commoditization of certain functions, a race to enter new markets and, of course, a furious battle for talent.

In the post-financial crisis period, Deloitte strengthened our leadership position in the management consulting space. But maintaining that position and adding to it requires an understanding and focus on the kind of impact clients are seeking and building ways to deliver it. The early and easy successes are behind us. What remains are challenging tradeoffs and the decision dilemmas that often paralyze leaders.

Using the three rules – and the research behind them – as a mental model has helped us see what works and what doesn’t. This model has helped us identify and understand the underlying principles behind our success, and even more critically, the importance of applying those principles rigorously in the years ahead. Reading the book - and through my ongoing conversations with both Michael Raynor and Mumtaz Ahmed – I found a remarkable alignment between their conclusions and the approach to building our business that Deloitte has implemented over the past several decades.

In many ways, the three rules are like many “golden rules” that are espoused when they are easily applied and dodged when it’s tempting to ignore them. From my point of view, it’s critical that all decision makers in our organization understand how decisions that are consistent with the rules have contributed to our past success as well as how we can apply the rules to difficult challenges we face today.

Rule #1: Better before cheaper

We see the elements of the Three Rules in several core pillars of our strategy as an organization. The first is where we choose to compete. While we are a full-service management consulting firm, we have to be selective in the kinds of services we provide, the kinds of clients we serve and the value we seek to produce. It's a difficult balance for companies to strike: no one can compete in peak form on everything, but determining where to focus and ensuring that focus isn't too narrow isn't always an easy choice. To give a basic example, if implementing Enterprise Resource Planning software solutions defines your firm in the eyes of your clients, it may be difficult for you to compete for strategy work.

What not to do. We have taken this reality to heart in several ways, especially when it comes to the connection between the fees we charge and the impact we deliver. First, we won't compromise service or quality that we feel is needed for a project just to win business. This sets us apart in our industry, precisely because firms sometimes "buy business" by underpricing services to gain share. When we don't feel we can deliver quality for that price, we do risk losing business. After all, our clients and potential clients are always making choices about the relationship between price and anticipated outcomes, and sometimes our assessment of what it takes to generate those outcomes does not resonate with them. Even so, our preferred strategy in such cases is to back away from bidding aggressively for that particular project, and instead stay engaged with the client to preserve the relationship. They may eventually draw the same conclusions we did about quality and price, and we want to be ready to serve the client if that's the case. Our hope is that they recognize the quality we bring to a project is worth the fees we believe are fair. We also recognize that we are not going to get every project – no company does – so we focus on managing our client relationships with an eye to the long term.

This approach to choosing where to compete for business does require the determination to stick with our assessment. It is difficult to walk away from potential business over pricing issues – especially when the loss of a client could imperil our near-term revenue targets – but we have to stay true to our analysis of where we provide value over the long term.

To give one basic example, we once held a commanding share of the market for cloud-based HR and financial tools software with our Workday product suite. As competitors followed us into the market at lower price points, we recognized the challenge. In our view, our pricing reflected what it took to do the work with the kind of quality we envisioned, and that wasn't something we were willing to compromise.

Although that decision, as expected, created room for our competition in that market, the long-term health of the organization depends upon a deserved reputation for differentiation based on quality service. If we were to respond in kind to every low-price, lower-service threat, we would not be able to invest appropriately in the essential building blocks for client service – talent, technology and innovation in services and products. Our potential for growth would be capped. It was a classic decision reflecting the first rule.

The "up market retreat" vs. innovation. At the same time, we guard against the sort of complacency that leaves successful companies vulnerable to disruption. We are constantly asking ourselves if what we might perceive today as a commitment to value might actually be an unwitting "upmarket retreat." Strategy often demands that we embrace certain

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tradeoffs, but we are always on the lookout for innovations or insights that allow us to break those tradeoffs and offer our clients superior service at lower cost.

This approach helps us cope with one of the realities of competing in management consulting. Services and products that once commanded premium pricing can be steadily adopted by clients or commoditized as competitors enter the space. It is vital to continuously provide greater value, and move nimbly into new products and services.

For example, several decades ago, much of our consulting work focused on inventory control procedures, and we were doing time/motion studies for our clients. Eventually, we worked with our clients so they could adapt these practices directly into their business, freeing us to focus on new services that would offer significantly more value.

In other cases, the industry-wide price level for a consulting offering may drop, and it is not feasible for us to choose not to compete. In such a case, our approach is to develop creative ways to do the work at still-profitable levels without letting quality suffer. Of course we accommodate the reality of price – but we don't compete on it.

A counterintuitive investment. This emphasis on quality requires greater management focus and attention than a price-based strategy. It also often requires additional investment, which is a counterintuitive response to price pressure. For example, in the case of ERP, an area once considered ripe for commoditization, we built a team focused on delivering high-end insights and paired it with cost-competitive professionals in India who could deliver quality work at a lower price point. The result is that we retained a $1 billion ERP business. In short, we developed a model for effectively competing in the market on a quality basis even when the overall market's price level dropped. We didn't let pricing dictate how effective we would allow ourselves to be.

Rule #2: Revenue before cost

By far, some of our most interesting Three-Rules-style strategies have involved the kinds of investments we make in our client relationships – investments that emphasize long-term revenue opportunities even at the expense of near-term costs. The normal model for management consulting leaves very little room for these kinds of investments, but we have chosen to tweak the model.

Value-based billing. For example, when we discuss a relationship a client or potential client, we are increasingly comfortable with a value-based billing approach. If it is agreed upon, we will spend more time upfront understanding the client's business and strategic needs. We then build a project that we believe will deliver the outcome they are seeking – and capture our proposed fees only when those outcomes are achieved. We do incur more risk in these types of projects, given that we are taking on costs with no promise of revenue unless we deliver the agreed-upon results. However, the revenue-before-cost approach is consistent with our goal of delivering impact in client work. The best part of this approach is that in many cases, these kinds of assignments create outsized gains for the clients – far beyond their initial goals.

Incidentally, this approach is also consistent with the better-before-cheaper rule; it helps us to preserve the quality approach we feel a project warrants to generate the best results rather than potentially sacrificing the value we can deliver to hit a lower price point.

In specific areas of service or industry strength, such as health care, supply chain and human capital, we have deployed value-based billing with great success. The clients recognize that we are sharing more of the risk. We are staked to goals that the clients themselves identify as paramount, and thus success is broadly shared. Because of the positive response to this approach, we see it becoming a more regular feature of our relationships with clients.

Growing from high-quality revenue. We recently completed the purchase of the Monitor Group, a firm with a rich heritage in strategic work.[4] By marrying Monitor with our existing strategy practice, we were able to achieve a new and higher level of brand recognition in an area that tends to offer greater rewards. Thus the investment in Monitor gave us access to higher-quality revenue.

Managing an ecosystem. Another revenue-before-cost approach has been what we call an "ecosystems approach" to our clients' issues. We look at what a client needs and, rather than focusing only what we believe we can do, we offer to bring to our client the kinds of organizations that will have the experience to deliver the necessary services, and we will coordinate their work. So, in the case of higher education clients, we have built an ecosystem of organizations that can help advance their efforts to digitize the learning experience: Building the necessary platform, creating the protocols around content, prescribing the needed devices and helping the client pin-point potential issues requiring executive-level involvement. This approach does involve significant investment on our part, but it permits us also to play at a higher level with the client and expands our potential pipeline of work.

Rule #3: There are no other rules

Some leaders would argue that The Three Rules only apply to core competencies that produce competitive advantage but not to support services. In many cases, companies outsource or cut those support services, seeing them as pure cost centers, not mission-central functions that require investment. It's tempting to think there should be different rules that should drive such investment decisions. But we disagree. We have found that Rules #1 and #2 apply even in internal operations.

For example, we recently invested in an internal effort to transform our finance function. Although not a single dollar of revenue was directly captured with this extra investment, we were able to make our overall business more efficient, effective and agile. In short, we approached our own business in the same way we would work with a client to help the finance team create more value for the organization.

As a part of that effort, we increased spending on a range of finance functions, including core finance capabilities, management reporting, financial planning, analytics and others. Among other benefits, we have been able to make better business decisions and more accurately predict long-term trends as a result.

The talent payoff. For instance, anticipating likely market demand and balancing it with our capacity to meet demand is a constant challenge in our profession. Aligning our hiring activities with short-, medium- and long-term demand is critical to our quality of service, to the financial health of our business and to our ability to make Deloitte Consulting LLP an attractive place to work. Our efforts to transform our finance function allowed us to perform our own internal and objective assessment of key business trends in a more powerful way, informed by data analytics, economic models and pricing analysis. As a result, we recognized that we needed to hire more aggressively among certain skillsets to meet

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expected demand in coming years. For us, having a good read on expected demand and the need for specific talent means being more competitive in recruiting, more selective in hiring, more effective in training and ultimately more successful in the marketplace when those predicted trends came to fruition. Our maxim – though we didn't articulate it at the time – was "better before cheaper."

We have taken a similar approach to our own thought leadership program, which several years ago was undistinguished, but has steadily risen in prominence to third overall in the most recent White Space quality rankings report, published by Source for Consulting.[5] We placed the thought leadership program under a senior leader, dedicated meaningful resources to staffing it, created new and higher standards for all market-facing materials and initiated several signature projects, including The Three Rules research project itself. The costs associated with this effort were not insignificant, but in the end, we made the effort precisely because we viewed our brand's value – and our distinctiveness in the marketplace – as being meaningfully tied to the quality and relevance of our thought leadership.

These kinds of investments are necessary because we seek to be most competitive when a project requires a combination of talents – strategy, implementation and deep industry experience. While we compete with organizations that focus on each of these areas, very few are able to make a compelling case that they can do all of them. That's because it's difficult: You have to invest in a diversity of talent and skills for the long term, make acquisitions steadily to augment your base-load and focus on coordinating your skills so that you serve clients. And even if clients are looking only for one specific dimension of what we do best, we don't finish a project without applying our other pillars of strength. To us, this is a simple expression of the philosophy of the Three Rules: We endeavor to deliver better, regardless of price.

That requires a applying a distinct worldview to the way we approach every major dimension of our business, especially talent. Like any large employer, there are going to be difficult choices around how to compete for and retain talent. Costs inevitably figure into the calculation. For example, during the post-2008 downturn, we had to reassess our own plans to hire – like every other major employer. But we continued to hire in anticipation of client demands as the economy rebounded. Our sense was that the added costs in the near-term would be more than justified by the caliber of talent we would capture.

In short, we look at the costs of hiring, training and retaining employees in a complete picture. That has helped us recognize certain kinds of talent-related expenditures as a way to avoid other kinds of costs – especially the costs associated with replacement, which are considerable, as well as loss of quality people, where the costs are even greater. For example, we realize that many of our top performers are motivated by factors besides cash compensation. So we have made a point of using certain prestige assignments and pro bono work as a form of reward for our top performers. As an example, when we began work for a highly recognized and respected corporation with a strong social responsibility mission, we were inundated with internal requests for the assignment, giving us a valuable way to reward highly motivated and strong performers. We didn't pay them more for that assignment, but many of them saw it as a plum opportunity and a way to feel even better about their work with Deloitte. With this kind of incentive, we have steadily raised our retention rate of our top employees.

Deloitte University. A key element of this long-term investment in talent is our commitment to Deloitte University (DU), a world-class training and learning facility located near Dallas. The decision to build DU came amid the shocks of the 2007-08 financial crisis, and it was tempting to either back away from the project or consider another model for training, such as web-based approaches now common to higher education. Yet we went forward with the $300 million investment, precisely because we saw a single campus as central to our brand, culture and our ability to deliver a consistent level of service. Through DU, we have delivered more than two million learning hours, a remarkable level in any organization. In addition, those sessions are often led by our own senior professionals – an additional expense. We considered using outside trainers and consultants to teach classes – at a lower cost – but in the end decided that our own people would be more enthusiastic, preserve institutional memory longer and drive home lessons with greater effectiveness.

DU also offers a collaborative, learning-oriented environment in which we have been able to host unique and engaging client programs. Involving clients in that experience has created opportunities for us to engage with them in new and valuable ways. Again, the Three Rules approach won out – and provided greater benefits than anticipated – even though a spread-sheet analysis would have supported a different decision.

Rules-based investment

The Three Rules' emphasis on seeking revenue is easily understood, but where it is particularly valuable is how it can be used to sort through the tradeoffs in the types of revenue one seeks. To give a simple example, it is easy to argue for growth, but it is much harder to emphasize investments in long-term revenue growth that come at the expense of near-term revenue growth. For example, we could incentivize our senior leaders to work on near-term client projects that sit in our core businesses. But instead, we have chosen to have some senior leaders investigate and build longer-term revenue growth opportunities that can open entirely new market opportunities. In effect, we give up the low-hanging fruit to seek out new orchards.

This approach requires discipline. Our own internal goal is to create products and services, or hybrid approaches, that can, on their own, become sources of $25 to 50 million in annual new revenue. At any given moment, we have at least a dozen such projects, and some have already established a clear path to meaningful revenue growth. Some of the projects now underway have very specific – and limited – applications in certain industries, such as health care, insurance or finance, but within those markets they enjoy significant revenue potential. Others could allow us to greatly improve our existing service offerings.

To invest in an emerging innovative product or service requires dedicated leadership and a funding stream that is protected against the usual budgetary pressures faced by most other areas of the business. It requires a diligent focus on commercializing ideas within a reasonable period of time. We recognize that in order to maintain our dedicated investments in new products, services and other innovations we must make hard decisions about investing in our existing core business. But that tradeoff, while difficult to do, is necessary to keep our organization positioned to move into new and adjacent businesses that carry potential for fresh revenue growth.

Of course, in a partnership structure like ours, the true proof of our commitment to revenue growth through new products and services is in our compensation model. When we

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Three questions for leaders

Leaders who want to assess whether their organizations use the Three Rules in their decision-making can ask themselves several key questions: Have we taken actions that emphasize quality over price competitiveness? Do we emphasize revenue growth over cost-cutting? Have we prioritized anything else over quality and revenue growth? Knowing the answers to these questions – and how frequently decisions have aligned with those principles – will help you assess whether the Three Rules are understood and applied in your business.

evaluate our senior leaders and agree on their compensation goals, our focus is not merely on how much revenue they manage. If they are tasked with developing solutions, products, services and new geographic markets, we will focus their compensation package on how they did in those realms. Again, this isn't easy to do. Compensation decisions in partnerships are closely tracked and any change sends a signal. In this case, we have chosen to signal clearly that we are going to reward leaders who develop innovations and strategies that can produce high-value revenue in the long-term. As the Three Rules suggest, you don't see a revenue-first strategy in easy decisions, but in hard ones.

A Three-Rules culture positions an organization for the future

Our approach, in short, reveals a bias towards non-price value over price and revenue over costs. We can't claim this bias was established by dictate – rather, it is part of the culture of our organization, nurtured over many decades and by many leaders. It is a culture that says: If we need to invest in our people to provide better service, we do it. If we see an opportunity to grow our business long-term at the expense of near-term results, we make it. And if we see a way to make our clients more successful even if we can't immediately profit, we have that conversation with them – not in the interest of capturing revenue but in the hope that they can position themselves best for the future. Our favorite exercise is helping clients see around the corner, and so whatever it takes to help them achieve that, we will invest in it. It's not one of the Three Rules, but it is a natural extension of the principles of better before cheaper, revenue before cost and not letting anything else come before those two guiding principles.

Notes

1. Mumtaz Ahmed, chief strategy officer of Deloitte LLP, and Michael Raynor, a Director of Deloitte Services, are the co-authors of *The Three Rules: How exceptional companies beat the odds* (Portfolio/Penguin, 2013). Starting in 2007, they worked on developing a rigorous statistical method for identifying exceptional performers with Professor Andrew D. Henderson of the University of Texas at Austin. A complete description of their method has been published in the Deloitte monograph "A Random Search for Excellence," available on Deloitte's website.

2. Facts and Figures: Deloitte US by the Numbers.

3. Andrew Hill, "Dissolving of Boundaries Lets in More Consulting Competitors," *Financial Times*, November 10, 2014.

4. Deloitte press release, "Deloitte Completes Acquisition of Monitor's Global Strategy Consulting Business," January 11, 2013.

5. www.sourceforconsulting.com/whitespace/

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