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**BUILDING AND DEVELOPING THE FINANCE SCORECARD**
How to create the strategically-focused finance function

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CASE STUDY: DIAGEO

Summary
Global organization Diageo has launched a corporate-wide ‘managing for value’ programme to drive up economic profit and total shareholder return. It has also integrated strategic and annual planning processes and implemented key performance indicators to track and predict performance against strategic objectives.

Introduction
Headquartered in London, UK, Diageo is a global consumer products organization operating in four business sectors: wines and spirits, packaged food, beer, quick service restaurants. Major brands include Guinness, Burger King, Pillsbury and Johnnie Walker whisky.

With about 72,000 employees, Diageo was the result of a merger in December 1997 between Grand Metropolitan (which owned Burger King, Pillsbury and the spirits producer International Distillers and Vintners, IDV) and Guinness (owners of United Distillers and the eponymous Guinness stout). For the fiscal year to 30 June 1999, Diageo reported an operating profit of £1903 million on a turnover of £11,795 million.

Total Shareholder Return
Importantly, Diageo also reported a total shareholder return (TSR) of 23 per cent. This is significant because the organization has set a stretch target of being – by June 2003 – one of the top five among a peer group of 20 leading consumer goods companies, as measured by TSR. This benchmark group includes high-performers such as Coca-Cola, Gillette, Philip Morris, Proctor & Gamble, Unilever, Nestlé, McDonalds and Kelloggs. As explained below, a portion of senior Diageo executives compensation is tied to performance against this peer group.

Managing for Value
Critical to driving up shareholder return within Diageo is the use of economic profit as the primary performance measure within the group. Economic profit is a measure of economic value added (EVA®), which, as explained in detail in Chapter 4, is a calculation of net operating profits after taxes minus a charge for the cost of the capital necessary to generate that profit.

Crucially, the organization recognizes that economic profit is not just a snapshot performance measure but rather an outcome driven by a complete management system. Therefore, Diageo has launched a corporate-wide
‘managing for value’ programme, which sets out to create the culture – supported by specific tools and techniques – that will enable the creation of economic profit.

As Diageo’s chief executive officer (CEO) John McGrath said in the 1999 annual report:  

“Managing for value is a key management process in Diageo. It will be critical to the achievement of becoming one of the top five companies in our peer group of 20. Managing for value is for everyone in the company, whether they are focused on growing one of our brands, improving the efficiency of our operations or supporting our businesses.”

Colin Heggie, senior vice president and chief financial officer (CFO) of Burger King, adds:  

“Managing for value is very much about ensuring that we’ve got a culture where the people making the business decisions are acting like owners.”

Managing for value as a central managerial philosophy was introduced into Diageo on day one of the merged entity’s existence. McGrath had championed the approach while CEO of Grand Metropolitan (and indeed while previously CEO of its IDV division).

Nick Rose, Diageo’s group financial director, says that when McGrath took the Diageo helm he saw it as the way to manage the new organization. Rose explains that creating this value-based mindset Diageo-wide has necessitated three interrelated processes:  
1. An analytical measurement process.  
2. An education process.  
3. A communication process.

**An Analytical Measurement Process**

Of the analytical measurement process, Rose comments that “the key first step was to develop a robust analytical system that would measures everything consistently and through a value-based methodology”. He states that taking economic profit down to a brand level and for each market proved a huge exercise:  

“For example, if you take just our IDV business there are over 7000 brand/market unit combinations, for which we have made an economic profit calculation.”

According to Rose, any company trying to develop economic profit to any level of sophistication immediately comes up against the problem of allocation. For example, allocating fixed asset/overhead costs to a brand/market unit level. He also makes the following valuable point:  

“I think economic profit or managing for value environments work best when the allocation of cost is done on an activity-based basis. The very best companies really understand their economic profit at a brand/market level with supporting activity-based data.”

Activity-based management and costing is discussed in detail in Chapter 5.
Examples of Analysis

In an article published in the Financial Times Mastering Management Review, McGrath gives two examples of how an economic profit analysis provided an understanding of true product profitability, and importantly how this was used to refocus the organization’s priorities.

The first example, taken from his pre-Diageo IDV days, focuses on Scotch whisky, which he said tended to sell well and being premium priced, normally generated good returns. But, he asked, does it create value? He writes:¹⁴

“Analyzing the real cost of holding such a long-term inventory of product… proved to be an illuminating exercise. The costs of maturing Scotch whisky, sherry and port tied up capital in such a way that, in one particular case, the return on it was inadequate – the process sometimes destroyed value… By contrast, our analysis highlighted drinks such as vodka and liqueurs that could be sold within weeks of distillation – the real value creators for the company.

“Conventional wisdom took a body blow from this innovative picture of what generated value and what didn’t. As a consequence, we switched funds from the lower value-added brands to the higher ones and diverted our advertising expenditure accordingly.”

This fund switching is a key process within Diageo today, as McGrath said in the organization’s 1999 annual review:¹⁵

“To get into the top five [of the peer group benchmark table] we need to be ruthless in reallocating resources – capital marketing investment and share of mind [thinking time] – to our primary brands; the brands which provide greatest shareholder value.”

The second example related to a US food service business, a part of the Pillsbury organization, which provides convenience products, such as part-baked bread, to outlets such as hospitals, restaurants and canteens. McGrath explained:

“Over a period of six months, it scrutinized every stock-keeping unit (SKU) – each product, in all its different sizes and formats, with reference to the retail channel through which it was sold – and found that 23 per cent were simply not creating value. Not only that, but its dealings with certain customers was not creating value either. In other words, we didn’t have a good food service business. We had a good business dragged down by a quarter of its operations.

“There is no automatic decision to eliminate the value-destroying SKUs. It may be, for instance, that they are necessary to ensure that we offer a consistent range of products. It may be that they can be converted from product offering – which destroy value – to products, which create it. Divestment is a last resort, in order to restore value.

“In the event, we did indeed reduce total SKUs by 23 per cent. Dealing with value-destroying customers was, naturally, far more difficult. One solution was to change the product mix – in other words, sell them something else. Because this improved the value resulting from our relationship, it improved the value that our customers got out of it. For instance, we sold several customers part-baked rather than frozen dough, which significantly cut their labour costs.”
Education Process

According to Rose, this process is about educating the organization as to what “managing for value” means, and how it will be used for the benefit of growing and developing the business. He states that at the outset the level of understanding of economic profit and managing for value varied across the organization:

“Therefore, what we did was develop a whole series of training modules and decision support tools, ranging from the very basic – what is economic profit and how does it work – all the way through to how to identify the key drivers and levers in a business which if pulled would make a difference in terms of economic profit.”

Diageo has five different modules that people can work through, depending on their level of sophistication. Rose continues:

“We also have a managing for value website that has a number of different tools and measurement systems, to help people work through managing for value and use it in their day to day environment.”

He adds that the website, which is constantly updated, is also useful for introducing new recruits to the managing for value philosophy, as they can start at with the first module and then go through each of the subsequent modules.

Another tool created by Diageo is a series of economic profit-based board games. Burger King’s Colin Heggie explains that these games are aligned to the context in which the managers work, so they immediately see their relevance to their everyday decisions:

“Basically, they take the principles of economic profit and convert them into a business case. Small teams then make decisions based on economic profit criteria and therefore can track the cause and effect relationship of making business choices based on managing for value principles.”

Within Burger King, all officers, directors and managers go through this exercise. Burger King also has a managing for value toolkit as Heggie explains:

“For certain specific decision-making processes we have models that are standard throughout Burger King. If, for example, we open a new restaurant, there’s a business and financial decision-making model that is consistent across the world.”

Burger King also has a new economic profit-based product development tool. At various stages in the product testing and decision-making process there are economic profit hurdles that have to be crossed in order for the development to continue. This is also consistently applied throughout Burger King’s global organization.

A Communication Process

Rose comments that the communication process has both internal and external components. About the latter he says:
“Most UK plc’s have grown up in a straightforward world of EPS [earnings per share] type measurements. However, we are now explaining to UK analysts and investors what managing for value means, why we are using economic profit and why we are focusing on this rather than more traditional financial performance measurements.”

**Devolution**

Internally, communication is crucial to the effective devolution of the managing for value concept. Indeed, Diageo intends to take the economic profit measure as deep into the organization as is practical. As with other companies profiled for this Report, understanding an economic profit value calculation is not seen as appropriate at every level. Instead the language will be articulated in a form that helps employees understand how their everyday actions can influence value creation. As McGrath says:

“Managers will explain what their teams can do, in practical terms, to improve EVA. Take a maintenance man on one of the production lines of the Pillsbury food business… the idea is to turn complex concepts into practical advice on a personal basis – for instance, reducing levels of breakdown, improving productivity, lowering costs, and increasing value.”

**Overcoming Resistance**

Rose admits that there was some early reluctance to using economic profit principles. He says:

“In the initial phase some people were a little reluctant to complete and publish the analysis. They felt that if they were running a business that was economic profit negative, then the immediate reaction from senior management would be ‘let’s sell that business’.

“However, as you deepen the understanding of managing for value, people realize the important issue is ‘value-creation’.”

Rose explains that this is about getting people to understand that moving economic profit from minus 10 to plus 10 is almost as valuable as going from plus 10 to plus 30. He continues:

“People, who at a point of time had a business that was negative, soon realized that if they could grow that to a positive number then that was real value indeed.”

Although most of the brand disposals that Diageo has made since the merger have been driven by their economic profit and competitive positions, and future growth and value creation prospects, Rose makes the useful observation that just selling a business that has a negative economic profit does not immediately create value. He explains that if potential purchasers perceive it as a business with a negative economic profit then they are going to pay correspondingly. As he explains:

“There isn’t an immediate panacea to creating value just by selling a business. However, there’s no doubt that the economic profit analysis shines a light on those businesses where you have some concerns. This then drives you to ask ‘can I do something about this?’ and if not, then ‘what are my options for that particular brand or business?’”
Incentive Compensation

As with most other organizations that take an EVA-type approach to managing the business, Diageo recognizes the critical importance of tying incentive compensation schemes to value creation. As Heggie says, “this is vital for aligning performance with decision-making and personal belief perspectives”.

Diageo operates two compensation schemes that are linked to value creation. One is a traditional EVA®-type approach through which bonuses are tied to economic value creation, where a portion of the bonus is ‘banked’ against future EVA® performance (this is explained in detail in Chapter 4).

In calculating this incentive programme, the first step for Diageo’s senior management was to calculate the market's expectations for the organization as a whole and for individual businesses within the company. They then set the improvement in economic profit for those businesses across three years and in line with those market expectations. That gave the target for bonuses. If managers exceed the expected improvement in economic profit, the bonus goes up. Of course the bonus can also go down and can be zero for a given year.

The other shareholder value-based compensation plan is a long-term incentive plan where senior management receive a bonus based on Diageo’s ranking against its peer group of 20 companies. No bonus is paid if the company is ranked 11–20, then an ascending scale of bonuses are paid from positions 10 through to 1.

To safeguard against executives receiving bonuses if the peer group performs poorly but Diageo performs ‘less poorly’, the organization’s remuneration committee ensures that the underlying performance of the company improves over time in real terms. Rose states:

“We believe strongly that economic profit improvements will eventually lead into share price improvement and therefore total shareholder return. Compensation is a critical part of the process of galvanizing people towards that goal.”

Key Performance Indicators

Another key philosophy that Diageo strongly supports is the use of key performance indicators (KPIs) as a management and performance reporting tool, which is used to manage progress against the organization’s strategic objectives.

Importantly, by using the KPI reporting approach, Diageo recognizes that driving shareholder value mean focusing not only on financial numbers but also on the non-financial drivers of that value. To this end, Diageo has articulated three areas of strategic importance:

1. Performance management (largely around financial performance).
2. Building brand excellence (essentially market/customer facing performance).
Therefore, the company believes, with really great people who have a strong performance ethic and are consumer-focused, it will secure sustainable financial success. Essentially, this is the thinking behind a classic balanced scorecard approach.

KPIs are created at Diageo level, at an individual business level and at market-facing levels within each business to support these strategic elements. Rose explains:

“At Diageo level there are relatively small number of KPIs which are consistent across – and applicable to – each of the businesses. Beyond that, each of the businesses and markets have some of their own KPIs that are not common.

“As an example, take a KPI like ‘volume’, which we believe is an important indicator for all the businesses. If you drop down to the Burger King set of KPIs you would see that restaurant traffic – ticket count – is an important KPI, but this doesn’t apply to any of the other businesses. And if you drop down further within Burger King you may find that the number of restaurant openings is an important KPI in one market but not in others.”

Indeed, Burger King had been using KPIs for some time prior to the Diageo merger. According to Heggie, there have not been any resulting radical changes to its KPIs but there has been some ‘fine tuning’, to align them with Diageo terminology and with its three strategic drivers.

Within Burger King, a summary high-level KPI template is created for the organization's key priority business units (PBUs). These are the country-based operations which are larger value generators for the business – the US, UK and Germany. Essentially, to succeed as a corporation Burger King must compete effectively in these three markets above all others.

As Figure 1.6 shows, this template reports monthly PBUs against the KPIs for the three Diageo strategic areas. For example, the performance management KPIs include system sales (volume), net trading profit after taxes and restaurant openings. The building brand excellence KPIs include market share, brand commitment (loyalty) and a customer satisfaction index score (brand image). The building talent KPIs include the percentage of development plans in place/actioned, the percentage of high potential talent retained over time and the percentage (named) nationalities in target population.

This Burger King template reports KPI performance for the PBUs to Diageo corporately. Therefore, Diageo receives a straightforward and robust one-page overview of how Burger King is progressing against Diageo’s strategic areas.

To drive forward KPI performance, Burger King has also created its own tailored version of the balanced scorecard. As Figure 1.7 shows, this is visualized as a circle. At the heart is ‘leadership and winning teams’, which provides the focus for the scorecard dimensions of:

• brand leadership
• market optimization
• product excellence
## Performance Management

### Key markets

- SEP
- System sales (volume)
- External sales (NSV)
- Trading profit
- NTPAT
- SIC
- Comparative sales
- Avg. restaurant sales
- Restaurant openings (gross)
- Restaurant count
- G&A
- Company restaurant operating profit as % total CO sales

### Brand Building Excellence

**Burger King Brand Performance**

- Market sales (OSR traffic)
- Ticket count (trailing 12 months)
- Average check
- Past four weeks usage (Brand penetration)
- Brand commitment (Loyalty)
- Consumer Satisfaction Index (Brand image)
  - CSS (% completely satisfied)
  - Mystery shop
  - RVA score (OSA score for UK)
- Brand Awareness: Unaided
- Advertising Awareness: Aided
- Share of voice

### Building Diageo Talent

- % of target population in "quadrant 4"
  (outstanding results combined with great behaviours)
- % positions with identified and unique successors
- % development plans in place/implemented
- % high potential talent retained over time
- % women in target population
- % (named) nationalities in target population

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**Figure 1.6: Burger King’s KPI Template**
Figure 1.7: Burger King’s Balanced Scorecard
• service excellence
• world-class franchising system.

The scorecard has been created at Burger King level and for each PBU (Figure 1.7 being the scorecard for the UK market)

Importantly, KPIs for these PBU scorecards are divided into three broad sections that relate to the performance management, building brand excellence and building Diageo talent strategic areas. Therefore, the market PBU KPIs support the Burger King scorecard perspective and create a direct line of sight with Diageo-level strategic dimensions.

An Integrated Planning Process

Moving to a KPI reporting process was a key element of a major refocus of Diageo’s planning process. Rather than using separate budgeting and strategic planning processes, Diageo now has a single integrated process. Essentially, the company completes a five-year strategic plan, year one of which is the annual plan. KPI reporting tracks progress against Diageo’s and the individual businesses’ strategies.

Rose explains that making this change has eliminated much of the redundancy in terms of time and effort created by the two separate processes. He says:

“Last year we did not have an annual planning process. Obviously we know what our budget for the year is, but we didn’t have a separate process for its development.”

He adds that KPI tracking and predicting shifts the balance from the outputs towards the inputs to the business:

“It means we can identify and solve problems earlier on in the business process as opposed to simply recording a disaster after it has happened.”

Heggie makes the important observation that through using KPIs, management is forced to focus on all its key constituents – shareholders, customers, employees and competitors:

“It forces through a discipline that’s far more all-encompassing and inclusive than a traditional budget is, which has historically been finance-centric and internally focused.

“While operating in a KPI framework, managers still end up with clearly articulated economic profit/financial targets. The process they go through is different, but it doesn’t change the financial discipline they must still adhere to.”

Global Shared Services Centres

Another business approach that Diageo is committed to is the creation of global shared services centres (this subject is discussed in detail in Chapter 6). Although very early in the process, Diageo will eventually set up several centres to serve geographic territories such as North America and Europe. Importantly the centres will serve all four of Diageo’s businesses, so there will not be
Developing the Finance Scorecard

separate centres, for example, serving Burger King and Guinness.

Rose is certain that the global shared services approach can add tremendous value to an organization such as Diageo. He says:

“Essentially we want our general managers and sales and marketing teams to be spending their time interacting with and serving the consumers. That’s their job, not worrying about processes such as accounts payable or payroll.”

Importantly (and in keeping with research into the findings from best practice shared services centres for this Report), Rose stresses that moving to this approach is not just about cost savings, although significant cost reductions can be achieved:

“Inevitably as you take out resources from each of the individual markets and you put them all in one place you will get economies of scale. However, that’s only one of many benefits from taking a shared service approach.”

According to Rose, among the other benefits are:

• a level of consistency and quality that is difficult to ensure when activities are scattered throughout the world
• the opportunity to create a platform from which additional change and improvement becomes much easier to direct and implement
• the ability to consolidate a huge amount of data in one location that will provide access and insight into the business that is difficult to access and compare when the data is geographically dispersed.

Rose also believes that the provision of data in a more usable form will help to facilitate better decision making within the businesses, thus driving up economic profit.

Finance Response to Change

With so much change taking place at Diageo, how is the finance function coping with the dramatic changes to the way it is being expected to think and act? Rose admits that there are undoubtedly some people who have been steeped in traditional ‘accounting’ measures of performance and who find this level of change sometimes difficult to embrace immediately – something that is common to any organization of Diageo’s size and complexity. However, he adds that a significant number of finance staff (in total around 4500 are employed in a finance capacity within Diageo) saw the changes as a natural way to manage a business today. He says:

“A great deal of change is going on within the finance function in Diageo and other organizations today. It’s all wrapped up in an idea that finance people should be much more involved as business partners, in shaping and influencing the drivers of the business rather than just being the scorekeepers or bookkeepers in terms of the financial outputs.”

To measure the effectiveness of finance staff, Diageo is implementing a 360-degree feedback mechanism (this is being institutionalized for all Diageo employees and essentially replaces the traditional manager-subordinate
appraisal process with one based on feedback from a range of people (for example, this could include the manager, team-members and internal customers). Rose explains:

“When they choose who will be part of that appraisal system finance people are expected to include business partners. And certainly part of the feedback will be around value-added to the business and not just their ability to add up the numbers.

“In that sense we are getting into a sort of scorecard as to how we are doing individually within the finance function in terms of adding value to the overall business.”

**Conclusion**

With so much organizational change going on within Diageo, the company is ensuring that potential problems are recognized. About economic profit, McGrath says:18

“Two words of warning. First, employee incentives must be tied to the shareholder value programme. It is the incentive that changes behaviour, and changing behaviour is what changes companies. This has certainly been the case within Diageo.

“Second, doing it intuitively does not work. A company has to go through the hard work of understanding how it works, introducing the detailed processes and imposing the disciplines.”

On the subject of managing a business with KPIs, Heggie says there are three critical success factors:

1. Senior and general management buy-in is vital. They have to change their way of working to use KPIs to manage the business.
2. An organization has to ensure it has the focus and ability so those KPIs are captured as part of the business process.
3. The KPIs themselves have to be clearly defined, objective and consistently measurable.

Heggie concludes by saying that if managers see collecting information on KPI performance as an exercise divorced from their core management activities, then the approach has either failed or the wrong KPIs have been identified.
Key Learning Points

Diageo is succeeding with its approaches to organization change because it has a number of fundamentals right. These include:

1. Economic profit is not seen just as a financial measurement but is central to the organization’s decision-making processes. This is driven by a corporate-wide ‘managing for value’ programme.

2. Diageo’s senior management team is totally committed to the principles of managing for value.

3. To drive managing for value, the organization recognizes the importance of interrelated analytical, education and communication processes.

4. Linked to the above, extensive training materials have been created to help managers understand and implement economic profit principles.

5. Diageo has tied incentive compensation mechanisms to shareholder value performance.

6. The organization has integrated its strategic and annual planning processes, thus eliminating a lot of redundancy in terms of time and effort.

7. Key performance indicators (KPIs) are used to track and predict performance against strategic objectives.

8. Crucially, only a small number of KPIs have been articulated at Diageo level. At individual business level, KPIs reflect their own critical success factors.

9. Diageo is committed to creating global shared services centres but importantly recognizes that benefits are not just around cost savings.