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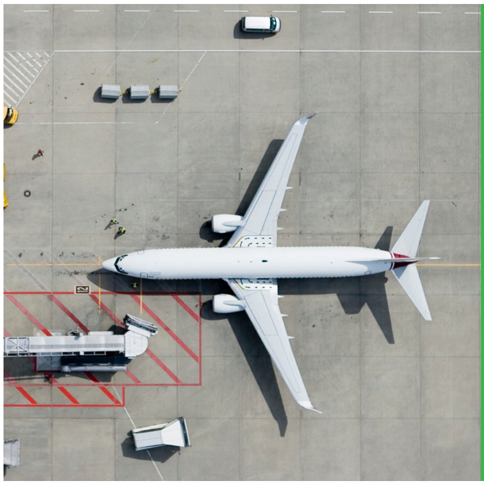

How Performance Management Can Help You to Navigate through Turbulent Times

Paper #1 – Introduction

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Information Management

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There is little doubt that we are in the midst of the worst economic crisis since the 1930s. Trillions of dollars have been wiped off corporate balance sheets, and governments around the world have been forced to act to avoid a financial meltdown. To survive, many organizations have had to take drastic action including mass redundancies and huge capacity reductions. But without deep knowledge of which costs add value, most businesses have cut through corporate muscle as well as fat making it even more difficult to sustain a healthy business. Everyone is asking the same questions. How did it happen? Who is to blame? Why didn't we see it coming? And, most importantly, what can we now do to survive, improve performance and start growing again?

While most commentators have blamed inept regulators, egotistical executives, self-centered salespeople and short-selling hedge funds, many business leaders have pointed their fingers at their performance management systems. Why didn't we have fast, relevant information that would have enabled us to respond more quickly and effectively? Why didn't we see the patterns, trends and forecasts that would have enabled us to take the right strategic decisions? Why didn't we know which business segments were creating value and which weren't so we could better allocate our resources? And why didn't we know how to cut costs without cutting value?

Answering these questions would certainly have helped leaders to better navigate their way through recent turbulent times but implementing the necessary management tools and information systems is not straightforward. While KPI (key performance indicator) dashboards, rolling forecasts, balanced scorecards and economic profit models - all within the framework of a web-based integrated performance management system – would appear to be high on the solutions agenda, it is how they are implemented and how the whole system works (not just the parts) that determines success or failure.

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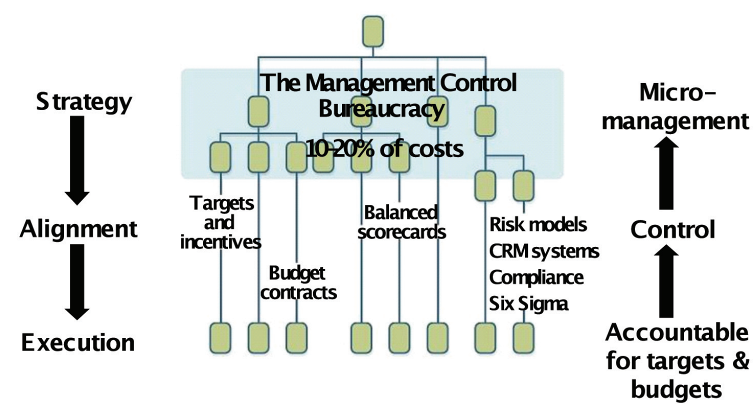
The trouble is that replacing the performance management system is only part of the story. Leaders also need to replace the top-down, multi-layered management structure it supports. This structure is expensive to run, slow to react and hard to change (see figure 1). And the problems are getting worse rather than better. Over recent years the management control bureaucracy has expanded in scale and cost as increasing numbers of standard setters, compliance officers, risk managers, performance controllers, internal consultants, quality inspectors, customer relationship managers and many other management roles have proliferated. And most of these roles have come with new tools (such as KPI dashboards and balanced scorecards), extensive training courses and time-consuming reports. The level of costs that add no value for the customer can be astonishing. While they vary with each particular study, rarely are figures of less than 20 percent quoted.

Figure 1 –The Traditional Performance Management System



Clearly, implementing more internal controls and external regulations have not prevented the current crisis. In fact, they could have made it worse by focusing managers on following the plan and explaining variances rather than looking at the road ahead and taking the right actions. The problem is that regulators are wired to the old top-down management model and have demanded more fixed targets, detailed budgets, and variance reports. And many new tools and systems have been caught in the netting of the same top-down control-oriented thinking. Applying more of the same thinking will not help organizations to survive and grow. They need to look for more innovative solutions.

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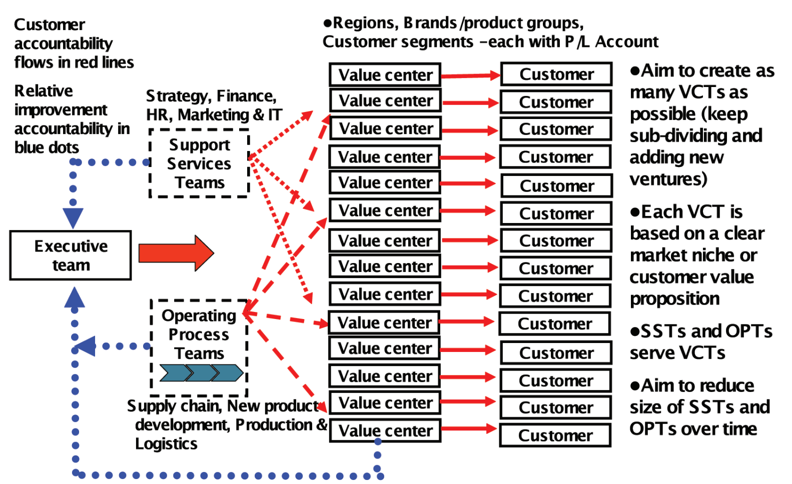
Toward a more accountable and transparent organization

More visionary leaders are looking at information systems, tools and controls in a different light. They believe the future lies in a more accountable and transparent organization. Leaders need to rethink the "accountability map." The first step is to turn the traditional vertically shaped organization on its side to face the customer. This new (horizontal) shape helps leaders to see more clearly where accountabilities should lie and how the information and reporting systems should flow. While leaders should aim to transfer accountability to as many teams as possible these changes are not so much about restructuring the business as changing the nature of relationships. Instead of the organization comprising of many units in a multi-layered hierarchy, the key change is that each unit is a link in a horizontal supplier-customer value chain that continuously connect and combine to deliver solutions to the paying customer (see figure 2).

Figure 2 – The Emerging Accountable and Transparent Organization (with hundreds of decision-makers)



Some leaders struggle with the idea that many small teams can actually cost less than a few large units. While economies of scale can look seductive on spreadsheets, creating many small teams leads to a more flexible and innovative organization that, with more accountability and transparency (and less top-down management control), actually consumes fewer costs. Toyota's stellar performance compared with its rivals has proved this point many times over.

In most organizations there are only four kinds of team (excluding temporary ones such as project teams). How you apply the new performance management to each of these teams is the key to a successful implementation. The four kinds of team are:

1. **The executive team (ET).** This is the C-level suite responsible for setting purpose, goals and strategic direction as well as challenging other units to maximize their performance.

2. **The support services team (SST).** These teams are responsible for serving and supporting value centers and process teams. They include strategy, finance, human resources, marketing, legal, risk and information technology. In large organizations the work of these teams is increasingly centralized (and often moved to shared services centers) and, in some cases, outsourced to third party providers. Support services teams can either be an integral part of a value center or serve a number of value centers.

3. **The operating process team (OPT).** These teams design, produce and deliver products and provide customer services and support. They do not usually have profit and loss responsibility. They include supply chain, design, production, logistics, sales and service teams. They are primarily accountable for (internal or external) customer outcomes. Like support services teams, operating process teams can either be an integral part of a value center or serve a number of value centers.

4. **The value center team (VCT).** These teams are responsible for formulating strategy, investing capital and delivering value (or profit). They are typically created around lines of business, brands/product groups and customer segments such as regions/countries. They start at the lowest level possible (e.g., a small branch of a bank) but can be grouped into numbers of units (e.g., a country or region). Each value center acts as a stand-alone business. They invariably have their own profit and loss accounts.

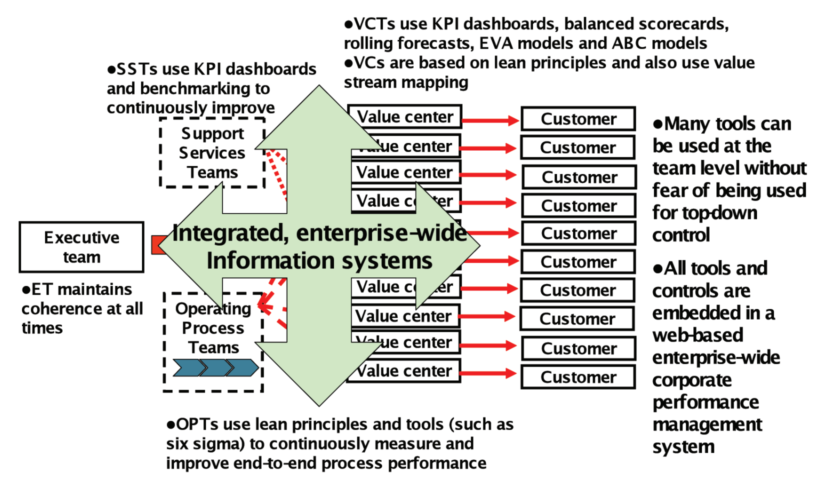
> *Leaders need to rethink the "accountability map." The first step is to turn the traditional vertically shaped organization on its side to face the customer.*

The aim is to create as many value center teams as possible by continuously sub-dividing them and adding new ventures. They should be based around a clear market niche and have a distinctive customer value proposition. On the other hand, the aim is to reduce the numbers and size of support services centers and operating process teams. In other words, the aim is to reduce indirect costs as far as possible. Value center teams are solely responsible for their results. They don't need much central control. But they do need to be challenged and supported. This model is not a soft option. If teams fail to perform consistently then they will not survive for long.

Integration with other tools and systems

The new horizontal accountability map makes the deployment of many management tools and information systems more clear and compelling (see figure 3). As one user noted, tools such as the balanced scorecard are 'turbo-charged'. The major problem with the use of most tools such as KPIs, balanced scorecards, rolling forecasts, economic profit and so forth is that they are used as additional top-down control systems within the control bureaucracy and stifle rather than encourage initiative and innovation. That's why most tools add costs rather than value.

Figure 3 – Tools are "turbo-charged"



The key change is that each unit is a link in a horizontal supplier-customer value chain that continuously connect and combine to deliver solutions to the paying customer

In the new model, tools help value center teams to formulate and execute their strategies. Coordination with other teams is critical but this does not mean locking together hundreds of scorecards and making it even more difficult to respond rapidly to unpredictable events. Also the new model is a clearer representation of the organization as a 'system' and enables leaders to embrace 'systems' or 'lean' thinking. There is more clarity around how work flows should be organized and which processes and activities add value for the customer and which should be eliminated. All the core ideas behind lean thinking, the strategy-focused organization, customer relationship management and economic value-added start to coalesce around the horizontal accountability map.

Another major development supporting the accountable and transparent organization is the power, speed and connectivity of Web 2.0. If Web 1.0 was about the web as an information source then Web 2.0 is about the web as a platform for participation and connectivity that includes such social networking sites as wikis and blogs that aim to facilitate creativity, collaboration and sharing among users. The emergence of Web 2.0 provides a framework for harnessing the ideas of thousands of people who can now interact and coordinate their actions in real-time across large, complex organizations and even whole ecosystems. Web 2.0 is a dynamic peer-to-peer network with everyone potentially connected to everyone else. Everyone has a voice. It is the ultimate democracy.

At the same time technology vendors have developed enterprise wide (web-based) performance management systems variously known as 'corporate' performance management (CPM), 'business' performance management (BPM) or 'enterprise' performance management (EPM). CPM involves the integration of planning, forecasting, scorecarding and business intelligence (or decision support) including financial reporting and consolidation. It uses a common database and the ability to display the data via a scorecard or dashboard interface. In a sense, CPM is to performance data what enterprise resource planning (ERP) is to transactional data: a broad embrace of all relevant information, fully integrated and thus providing a single view. The whole point of a web-based CPM system is to empower people by enabling them to access whatever information they think will be useful to them. Everyone is on the same page at the same time. The result is more coherent and effective decision-making.

Like Web 2.0, the new management model will be radically decentralized with many more decisions being taken at the periphery rather than at the center. It will be much easier to change than before. The problems of disparate information systems and disconnected controls are receding. Controls can be at the front-line and at the corporate center at the same time. Empowered teams that can respond rapidly to change can be deployed without the side effects of poor coordination and control. Knowledge can be shared instantly. The glue that holds this model together will not be centralized authority and enterprise-wide budgets but a shared vision of where the firm is going together with clear (horizontal) lines of accountability and open, transparent information systems. Resources will be more easily accessible and teams will be encouraged to experiment with new solutions, processes and business models. And rewards will be shared fairly across all teams and their members. Transparent information systems are likely to become the most effective management control system available to any organization in the future.

Realigning targets, measures and rewards

Remapping accountability and information flows only takes you so far. Leaders also need to realign targets, measures and rewards. In other words, if managers continue to be driven by fixed targets and evaluated and rewarded against them, they will be unlikely to change their short-term thinking and behavior (a key contributor to the current problems). Leaders need to implement more supportive systems based on a management scorecard that reflects business priorities. Though the approaches vary, the common factors are that teams are evaluated on a range of criteria (like a school ‘end-of-term’ report) rather than on fixed targets.

While economies of scale can look seductive on spreadsheets, creating many small teams leads to a more flexible and innovative organization that, with more accountability and transparency (and less top-down management control), actually consumes fewer costs.

Figure 4 shows an example of such a scorecard for a value center team. The first step is to agree the assessment criteria and how the evaluation process will take place. Column (a) enables these criteria to be 'weighted' to lay greater emphasis on some criteria over others (for example, maximizing cash flows through the current crisis). Column (b) is the assessment score and can be supported by 360 degree scoring systems. The final column reflects the weighted score and enables rewards to be paid based on the percentage score achieved. This percentage can relate, for example, to multiples of base salary (e.g., senior managers might be entitled to 54 percent of three months salary, middle managers to 54 percent of two months salary and so forth). The performance criteria for these scorecards will vary by type of team. For example, a support services team will want to emphasize partner satisfaction and costs; a process team will concentrate on cycle times, quality, cost, and customer satisfaction; and a value center team will focus on strategy execution, innovation and value creation.

Figure 4 – Value Center Team Accountability Scorecard	Weighting	Score (out of 100)	Weighted average score
Performance evaluation criteria	(a)	(b)	a x b
How well are we maximizing free cash flows?	40%	60	24.0
How well are we doing relative to peers (based on a range of KPIs)?	10%	40	4.0
How well are we managing our strategic investment portfolio?	10%	50	5.0
How well are we innovating?	10%	30	3.0
How well are we attracting and retaining key people?	10%	60	6.0
How well are we satisfying our customers?	10%	80	8.0
How well are we collaborating with partners?	10%	40	4.0
TOTAL	100%		54%

The accountability scorecard works well without a fixed target. It is based on a judgment of how well the team has performed. Performance measures are the 'evidence' rather than the rule. The aim of each team is to 'be the best' and this means continuously improving against peers, best practices and prior years. It uses the power of pride, passion and peer-pressure (all intrinsic motivators) to drive improvement.

Six implementation guidelines

1. **Re-map management relationships** around four types of management team: executive team, support services team, operating process team and value center team. Ensure that while customer accountability flows left-to-right (toward internal and external customers), results accountability (based on relative improvement) flows right-to-left (toward the corporate center). Justify creating large numbers of small teams on their self-driven innovation and value creation potential. Think about low management costs rather than economies of scale. Give team members different responsibilities. For example, in one production team, a team member was assigned responsibility for health and safety; another for training; a third for housekeeping and so on.

2. **Focus support services teams on becoming valued and trusted business partners.** Where possible, keep support services within the value center umbrella.

3. **Focus operating process teams on satisfying (internal or external) customer needs.** The more support services and operating processes that are encompassed within value centers the easier it is to drive and evaluate performance.

4. **Create as many value center teams as possible based around, for example, lines of business, brands, branches and customer segments.** Ensure that though value centers are often 'clustered' into regions and divisions their individual results are open and transparent and can be seen by all teams at all times. Also ensure that each value center has responsibility for a profit and loss account. Include as many direct costs as possible in value centers.

5. **Use the right performance management tools and information systems to support the horizontal accountability flows.** Ownership of tools should be at the team (not the corporate) level. These might include KPIs, rolling forecasts, balanced scorecards and self-service reporting systems. All tools and systems should be part of an integrated and coherent corporate-wide information system so that every manager can see the same information at the same time.

6. **Realign targets, measures and rewards.** Design a management scorecard with assessment criteria that reflect current priorities. Ensure that all team-based rewards are shared with all members on a fair basis

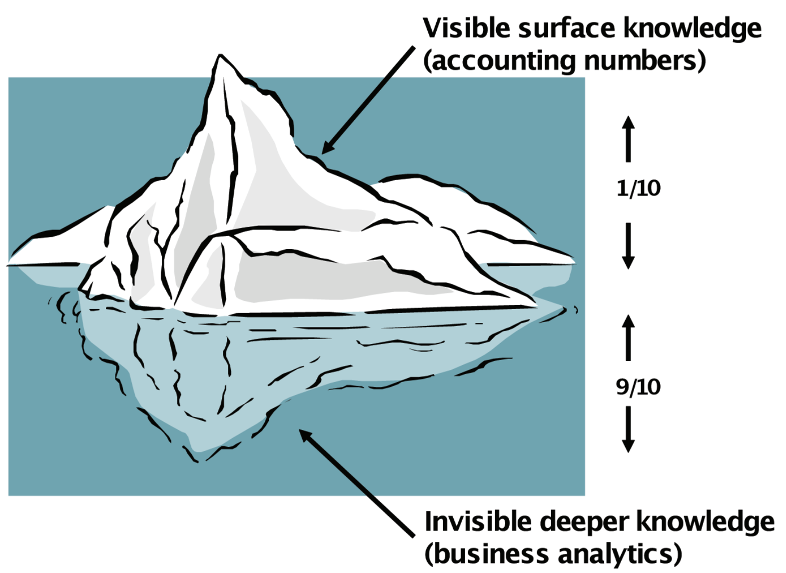
The new horizontal accountability map makes the deployment of many management tools and information systems more clear and compelling.

The Next Four Papers

Clear (horizontal) lines of accountability and open, transparent information enable leaders to implement fast, relevant management information systems that provide real performance insights. But these insights are not readily found within the traditional accounting system. Like a 'knowledge iceberg' (see figure 5) managers need to look deeper at the business analytics that lie below the surface. These are the insights that will help you to navigate through the turbulent times ahead. We will describe these in the next four papers:

1. **Know where you are today.** Every organization is increasingly vulnerable to short-term twists and turns and thus needs to manage its cash and profitability more effectively. But most information flows around the business at a glacial pace. In fast changing markets filled with fickle customers, managers need to know immediately if further action is required. And even if the information flow can be speeded up, leaders are reluctant to share it with others. In the new model, information is fast, open and transparent. Leaders need to provide a common IT platform that enables all managers to see the same information at the same time and gain rapid insights into what's happening right now. A few well chosen key performance indicators should be available at every level and act like a radar screen to enable managers to avoid threats and seize opportunities. The speed and quality of information is a key feature of the new control system.

Figure 5 – The Knowledge Iceberg



Coordination with other teams is critical but this does not mean locking together hundreds of scorecards and making it even more difficult to respond rapidly to unpredictable events.

2. **Know where you're going in the near-term.** Not only do most organizations suffer from slow information (often lacking relevance), but they also have little visibility into the near-term future (i.e., 3-18 months ahead). Needless to say this is a critical handicap in turbulent times. While most do budget revisions quarterly, they only look toward the fiscal year-end (and this process is often blighted by some managers who manipulate the numbers to protect senior people from bad news). The problem is that there are no 'rolling' plans or forecasts that enable managers' to continuously see ahead and take the right decisions. Rolling forecasts are a key control and decision support process in the new performance management system. They inform leaders about future cash flows and capacity needs. And they give them extra time to deal with changes in customer demand.

3. **Know where value is created and destroyed.** Many business segments such as product lines and customer channels are poor performers but the drain on profitability and cash flow is often hidden within more aggregated accounting numbers. In a management structure with many more accountable value centers it becomes clear which teams are creating value and which are not. The executive team needs to act more like a venture capital provider always prioritizing resources to the best opportunities. By terminating poor performing businesses and placing these resources into new ones, profitability and cash flows can be transformed.

4. **Know how to cut costs without cutting value.** It is reckoned that up to 40 percent of costs add no value for the customer but traditional accounting systems can't readily identify them. In the new model there is a sharp focus on eliminating waste by improving processes rather than managing budgets. All managers are looking to improve speed and quality and cut out unnecessary work. And they are continuously aligning capacity with changing demand (rolling forecasts help to anticipate changes in demand). It is important to note that whatever the latest plan says, teams respond to prevailing demand. Resources are 'pulled' through the system by customer orders rather than 'pushed' by the plan.

Too many organizations are making key decisions based on inadequate information rather than using fast information and deep performance insights to make well informed decisions. This can make the difference between survival and failure. Choosing the right tools and information systems and implementing them well (within an accountable and transparent organization) is the key to navigate through the economic crisis. Today is probably the best time to make these difficult changes and build a platform for future, sustainable success.

About the author
Jeremy Hope is a cofounder of the Beyond Budgeting Round Table. He has written four books on performance management including "Reinventing the CFO", all published by Harvard Business School Press. He has helped many large organizations to improve their performance management systems and is also a keynote speaker at many conferences on performance management. You can contact him at jeremyhope@bbrt.org or call 44-1274-533012

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