Innovation in Action Series
May 2009

IBM

Performance management in the innovation age: An introduction

Author: Jeremy Hope, Beyond Budgeting Roundtable

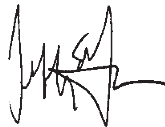
Information Management

Cognos. software

Answer true or false: The most successful CFOs directly control every aspect of their organizations with a rigid system of functional hierarchies, budgetary controls, and target-based rewards. If you said true, you're way behind the curve in understanding effective performance management systems.

In this article, Jeremy Hope argues that the key to real performance management is innovation. Success in highly competitive, rapidly changing markets demands new ways of thinking, shared responsibility, easy access to information, and rapid response to threats and opportunities. The ponderous top-down, command-and-control management style is outdated, stifles innovation, and practically guarantees suboptimal financial and operational results.

"Performance Management in the Innovation Age: An Introduction" is the first in a new series of papers written for the IBM Cognos® Innovation Center for Performance Management by Jeremy Hope, Research Director of the Beyond Budgeting Round Table. Jeremy is an advisor to the Innovation Center. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.



Jeff Holker
Associate Vice President
IBM Cognos Innovation Center for Performance Management

Today's buzzword is *innovation*. CEOs and business gurus gathering at the 2006 World Economic Summit in Davos, Switzerland never stopped talking about it. "Efficiency gains have run their course," they said. "The only way to improve performance and satisfy shareholders is to grow the top line," was another common statement. General Electric CEO Jeff Immelt believes that constant reinvention is the central necessity at GE. Howard Stringer, CEO of Sony, agrees: "We will fight our battles, not on the low road to commoditization, but on the high road of innovation." Ed Zander, Motorola CEO, has also got the message: "All I've done since I got here is focus on one word—*innovation*."

The reality however, is that most large organizations are wired for command and control rather than innovation and adaptation. Most are unable to grow continuously without disruptive acquisitions. A recent UK survey of 300 companies showed that few senior managers are ready to adopt ways of encouraging innovation, even though they admit it is a shortcoming. Meeting short-term targets is part of the problem. While corporate leaders are supposed to base key decisions on net-present-value calculations (typically using long-term forecasts), 78 percent said they would sacrifice value—in some cases a lot of value—in order to smooth earnings.[1]

The problem leaders face is that innovation and adaptation can only be enabled and encouraged by a supportive management culture alongside the right performance management systems. Neither can be dictated or directed from the center. This means devolving more responsibility for strategy, planning, forecasting, decision-making, and control to self-managed teams, and then trusting them to use information to self-regulate their performance. That's why leaders need to pay attention to their *performance management models*. Ultimately, it is these models that either enable and encourage innovation or strangle and destroy it.

This is the CFO's dilemma: To compete successfully in twenty-first-century global markets, organizations need to respond more rapidly to threats and opportunities, and create a climate for continuous innovation and organic growth. But CFOs also

know that their top-down control systems—based on performance contracts and budgets—are barriers to change. So how can a CFO be comfortable with becoming a business partner who supports continuous innovation and rapid response, yet maintain an independent control-oriented perspective? How can the guardian of an organization's finances and controls be confident that devolving strategy, planning, and decision-making to teams closer to the customer won't unleash a wave of uncoordinated and uncontrolled expansion that will ultimately destroy the business? These are the questions that this new series of *Innovation in Action* papers will try to answer.

The innovation economy

Critical success factors are moving inexorably from capital, scale, and efficiency to knowledge, collaboration, and innovation. In fact, according to Davenport, Leibold, and Voepel, we are now entering the *innovation economy*. They describe the challenge in terms of how organizations can continually adapt, shape, change, innovate, create, and network to survive and prosper in global market environments that are quickly becoming more unpredictable, with organizations that have become more virtual, mobile, and porous, with technologies that are becoming revolutionary and integrative, and with people that are more independent, knowledgeable, assertive, and mobile.[2]

The innovation economy (see *Figure 1*) is driven by disruptive changes caused by globalization, deregulation, new technologies, empowered customers who co-create solutions, and the switch from financial to intellectual capital as the key driver of value (intellectual capital—the value of brands, innovation capability, loyal customers, and so forth—now accounts for around 80 percent of value creation in 2005 compared with zero in 1980[3]). The switch in power from the supply chain to the demand chain (including marketers, brand managers, consumers, designers, and retailers) is forcing all suppliers of goods and services to be more innovative in order to meet changing customer needs. The life cycles of products, strategies, and

business models are shrinking, placing greater pressure on the speed of response and strategic renewal. The entry cost (and speed of entry) into most markets is falling; intangible resources drive value; and innovation has moved from the exclusivity of the R&D department to anyone, anywhere, any time.

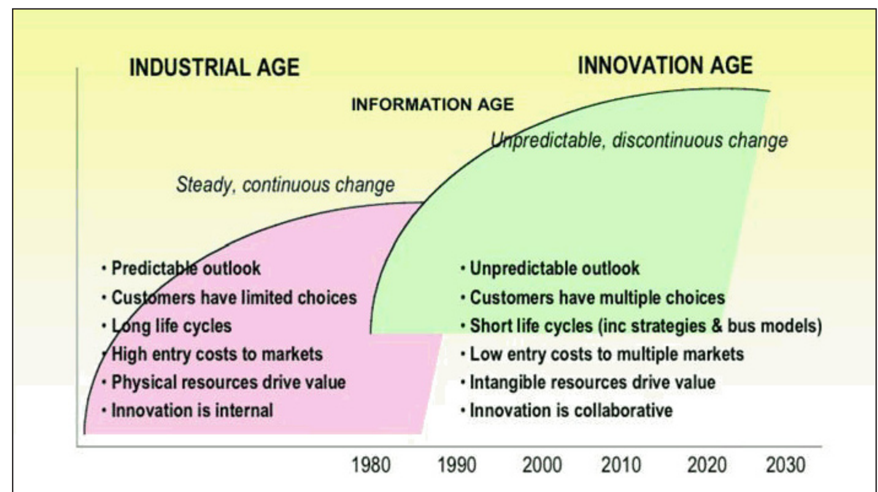


Figure 1 – The world is moving from the industrial to the innovation economy

But perhaps the most dramatic change is the decline in transaction costs that has caused traditional organizational boundaries to evaporate. In the industrial economy, information was often imperfect and hard to acquire. This led to high transaction costs and encouraged companies to integrate vertically. It was far less expensive for firms such as Ford or General Motors to source their own parts internally than to search the globe for suppliers. But falling information costs driven by the Internet, greater speed and processing power, and increasing levels of storage capacity have changed all that. Knowledge is now abundant, free, and easily accessible from anywhere at any time. Even physical resources can be acquired and shipped quickly, often at a much lower cost than producing them internally. And an expanding range of outsourcing services offers new levels of flexibility as well as lower costs.

Such changes have disrupted traditional industry groups and value chains. Many management principles and practices accepted today as "the conventional wisdom"—such as economies of scale, hierarchy, vertical integration, restructuring and reengineering, strategic planning, budgeting, extrinsic rewards, enterprise resource planning, supply chain synchronization, and customer relationship management—are being challenged. The typical industrial business model was geared to making and selling products and services to customers who were distant "objects" (and often reluctant buyers). But the shift from "the value is in the stuff" to "the value is in the service the stuff provides" is changing consumer perceptions and behavior.

Preparing for the innovation economy means much more than beefing up R&D departments and increasing the rate at which new products and services are introduced. It means adopting new management models and control systems that support continuous innovation and adaptation. For those CFOs who consider this move too risky, Gary Hamel has some advice: "Which number is bigger in most companies, the amount that has been written off over the past decade for hanging on to the past for too long, or the amount that has been written off because the company experimented with the future too soon? Being incremental may be the biggest risk of all."[4]

The problem is the 'management factory'

Devolving decision-making and enabling innovation and adaptation are a long way from where most companies are today. But for all its flaws, the command-and-control (budgeting) model was coherent around the unifying theme of central control. In this model, leaders set the strategy and managers implemented it. Performance management was about translating strategy into plans, budgets, and targets, and then controlling performance against them. The company decided what to make and sell, and then it was up to the marketing and sales teams to persuade customers to buy the required volumes of products and services. Companies

operated within known boundaries and competed with identifiable firms at different points on the value chain. It was a model based on contract, compliance, and control. Strategy case studies such as *Coke versus Pepsi* were played out in every business school classroom and simulated the real thing.

At the core of this “fixed performance contract” are targets and budgets that must be met by the end of a period (usually a fiscal year). The problem is that setting fixed financial targets and budgets—then placing everyone under pressure to meet them—is a recipe, not for exceptional performance (unless the market is conveniently heading North at the same time), but for a mad scramble at the end of every period as managers throughout the organization find ways (by fair means or foul) to meet them.

Targets and budgets are just a few of the top-down control systems that flow from an expanding “management factory” that dictates and directs what happens in the lines of business. Over the past twenty years or so, these traditional systems have expanded in both manufacturing and service industries and mushroomed in the public sector as targets, budgets, and a wide array of tools and techniques such as Quality Control systems, Balanced Scorecards, CRM systems, Six Sigma, and Benchmarking tools have proliferated. The management factory can often represent several layers of management, since the people who work there do little else but handle information and make decisions that link high-level strategy with front-line execution (see *Figure 2*).

The management factory is also the source of large amounts of non-value-adding costs. Consider that just 13 percent of General Motor’s workers actually make cars; only two-thirds of New York City’s teachers actually teach in classrooms; and a bare ten percent of a salesperson’s time is spent in front of customers. In a 2006 interview, General Electric CEO Jeff Immelt lamented that 40 percent of GE consists of unproductive administration and back-office work, and he wants

to halve it in five years (and GE is generally acknowledged to be one of the best managed companies in the world!). Contrast this with an organization such as the Swedish bank, Svenska Handelsbanken, where 50 percent of staff have lending authority.

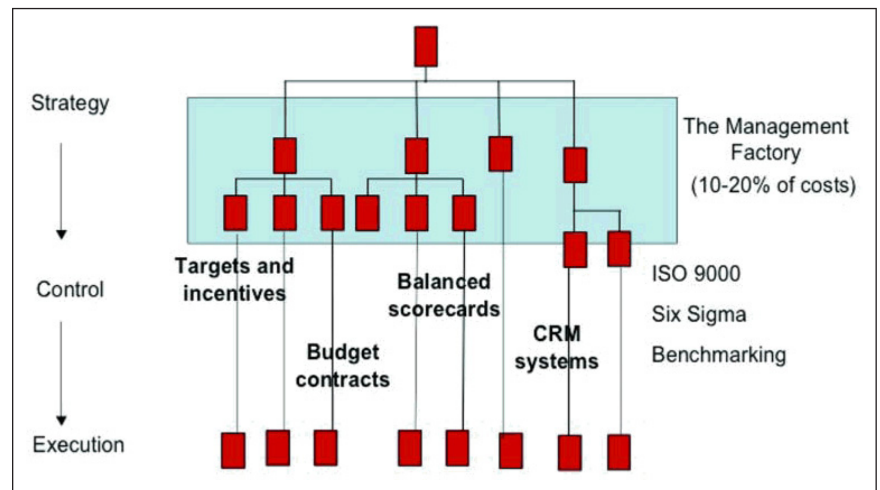


Figure 2 – The stifling impact of the management factory

While many leaders are trying to drag their organizations (often kicking and screaming) into the innovation age, they are faced with the insurmountable barriers of the management factory whose barricades are manned by some of the most powerful vested interests in the firm. This leads to a collision of cultures as the new world of horizontal processes and self-managed teams meets the old world of vertical reporting and line management. The battleground is often concerned with openness and transparency of information as entrenched controllers continue to deny process leaders access to the knowledge they need to make key decisions.

Leading organizations are dismantling the management factory. Their focus is on liberating front-line teams and fostering self-regulation, collaboration, and management by exception. CFOs are realizing that fixed plans, targets, and budget contracts collide, rather than connect, with horizontal processes and are the nemesis of adaptive and innovative organizations. Such old-school approaches need replacing by performance management models that support self-regulation and continuous relative improvement, rather than central control.

Going beyond budgeting is the way forward

What's needed is a new "joined-up" management model that aligns management practices across the organization. Instead of constantly realigning and restructuring the "budgeting model" (and in some cases stretching it to the breaking point), some organizations are replacing it altogether with a new coherent "beyond budgeting" model (see *Figure 3*). In this model, planning and decision-making devolve to a number of self-managed teams who are accountable for continuously improving their performance against peers and market movements. Ethical behavior and reporting are critical, as they are the only way to maintain credibility and keep one's place in the value-generating eco-system. The strategy focus is on learning, adaptation, and renewal rather than on annual planning processes and tools. And the organization collaborates to a much greater extent with external partners up and down the demand and supply chains. This is facilitated, not so much by implementing expensive systems, but by building relationships and removing barriers such as targets and incentives that encourage hoarding rather than sharing.

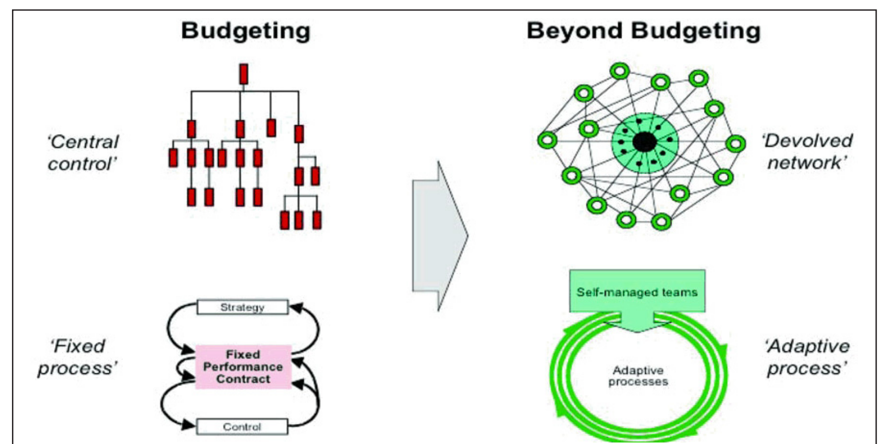


Figure 3 – The shift to a 'beyond budgeting' model

To accommodate these changes, the finance team has to dismantle the management factory, reduce detail and complexity, stop micromanaging, and allow front-line teams to take over the planning and control tasks. Annual plans and budgets must be replaced with processes based on continuous planning and rolling forecasts, and the provision of fast, relevant information to front-line teams who self-regulate their performance. Trend reporting enables managers to ask the right questions and make the right decisions. And integrated, transparent information systems provide essential checks and balances that support good governance.

At the operational level, the focus moves from selling products to building customer relationships. Lean thinking is fully embraced and the old functional measures give way to process measures that focus on customer outcomes instead of boxes on the organization chart. Fewer top-down control systems are needed, as information is integrated in the work, leading to huge cost savings. Performance appraisal and reward systems are changed to place the emphasis on the team and ensure that everyone is treated fairly.

A recent study by McKinsey & Co confirms these conclusions. Over the four years prior to 2006, McKinsey surveyed 230 global companies and over 115,000 individual respondents to gain a better understanding of which factors drive successful organizations. They concluded that no single magic “fix” such as KPIs or incentives was effective. In fact, most executives systematically overestimated the impact of a single practice. Their conclusions were that the carrots and sticks of incentives appear to be the least effective of the options commonly used to motivate and encourage employees to perform well and stay with a company. Applied in isolation, KPIs and similar control mechanisms (such as performance contracts) are among the least satisfactory options for improving accountability; reliance on a detailed strategy and plan is far from the most fruitful way to set a company’s direction; and command-and-control leadership – the still-popular art of telling people what to do and then checking up on them to see that they did it – is among the least effective ways to direct the efforts of an organization’s people.[5]

The McKinsey report tells us that the only successful approach is a combination of management practices used in the right way—including establishing clear roles within a structure matched to the needs of the business (accountability), articulating a compelling vision of the future (direction), and developing an environment that encourages openness, trust, and challenge (culture). They state that each of these practices works best in relation to a specific outcome, but applied in combination, they are mutually reinforcing, and produce much more dramatic results.

In our 2003 book Beyond Budgeting, Robin Fraser and I identified a set of twelve principles that have since been adapted to reflect our latest thinking (see *Figure 4*).

Principles of the 'beyond budgeting' model
1. Customers—Focus everyone on their customers, ***not*** on hierarchical relationships.
2. Organization—Organize as a lean network of accountable teams, ***not*** as centralized functions.
3. Autonomy—Give teams the freedom and capability to act, ***don't*** micro-manage them.
4. Responsibility—Create a high-responsibility culture at every level, ***not*** just at the top.
5. Transparency—Promote open information for self-management, ***don't*** restrict it hierarchically.
6. Governance—Adopt a few clear values, goals, and boundaries, ***not*** detailed regulations.
7. Goals—Set relative goals for continuous improvement, ***don't*** negotiate contracts.
8. Rewards—Reward shared success based on relative performance, ***not*** fixed targets.
9. Planning—Make planning a continuous and inclusive process, ***not*** a top-down annual event.
10. Controls—Base controls on relative indicators and trends, ***not*** variances against plan.
11. Resources—Make resources available as needed, ***not*** through annual budget allocations.
12. Coordination—Coordinate interactions dynamically, ***not*** through annual planning cycles.

Figure 4 – Principles of the 'beyond budgeting' model

When asked in an interview with German business magazine *Zfo* whether UBS Wealth Management had partially abolished budgeting, CFO Anton Stadelmann replied:

"We have not partially abolished budgets, we have abolished them altogether. We only budget at management board level, and that in the sense of strategic considerations, without breaking these down further. It is a logical result of our new direction that we have abolished budgets because budgeting is a defensive element. In the budget process, the aim is to negotiate the lowest level of ambition possible in order to be able to exceed it as far as possible. To this effect, you look for reasons why you cannot afford something. Therefore, budgeting contradicts our growth thinking. We would prefer to ask ourselves why and how we can afford something. We are replacing the budget with internal benchmarks as our reference points for performance appraisal."[6]

While UBS WM is a recent convert, companies such as Svenska Handelsbanken, Toyota, ALDI, Southwest Airlines, Whole Foods, Guardian Industries, and Egon Zehnder have been operating with this model for many years and, without exception, they are consistently at (or near) the top of their industry peer groups on a wide range of indicators. None of these changes could have been made without the support of the CFO and the finance team. In each case, CFOs have understood the behavioral effects of their systems and replaced worn-out budgeting practices with more open and transparent information systems and self-regulating controls. In this way, they have become true business partners (rather than remote controllers) who understand the business and how to support innovation and growth.

The eight papers that follow in this series will look at different aspects of performance management in the innovation age. They are:

2. "Why management models and metaphors need to change"

3. "How to break free from the short-term performance trap"

4. "Define success in relative terms"

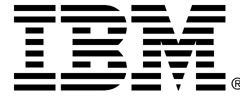
5. "Why strategy should be a direction rather than a destination"

6. "Release the power of self-managed teams"

7. "Why management tools don't work"

8. "How to keep the board informed and in control in times of change"

9. "Why integrated, transparent information systems provide more effective control"



About the IBM Cognos Innovation Center for Performance Management

The IBM Cognos Innovation Center was established in North America and Europe to advance the understanding of proven planning and performance management techniques, technologies, and practices. The Innovation Center is dedicated to transforming routine performance management practices into "next practices" that help cut costs, streamline processes, boost productivity, enable rapid response to opportunity, and increase management visibility.

Staffed globally by experts in planning, technology, and performance and strategy management, the Innovation Center partners with more than 600 IBM Cognos customers, academics, industry leaders, and others seeking to accelerate adoption, reduce risk, and maximize the impact of technology-enabled performance management practices.

About IBM Cognos BI and Performance Management

IBM Cognos business intelligence (BI) and performance management solutions deliver world-leading enterprise planning, consolidation and BI software, support and services to help companies plan, understand and manage financial and operational performance. IBM Cognos solutions bring together technology, analytical applications, best practices, and a broad network of partners to give customers an open, adaptive and complete performance solution. Over 23,000 customers in more than 135 countries around the world choose IBM Cognos solutions.

For further information or to reach a representative: www.ibm.com/cognos

Request a call

To request a call or to ask a question, go to www.ibm.com/cognos/contactus. An IBM Cognos representative will respond to your enquiry within two business days.

IBM Cognos
Innovation Center
for Performance Management

© Copyright IBM Corporation 2009

IBM Canada
3755 Riverside Drive
Ottawa, ON, Canada K1G 4K9

Produced in Canada
May 2009
All Rights Reserved.

IBM, the IBM logo and ibm.com are trademarks or registered trademarks of International Business Machines Corporation in the United States, other countries, or both. If these and other IBM trademarked terms are marked on their first occurrence in this information with a trademark symbol (® or ™), these symbols indicate U.S. registered or common law trademarks owned by IBM at the time this information was published. Such trademarks may also be registered or common law trademarks in other countries. A current list of IBM trademarks is available on the Web at "Copyright and trademark information" at www.ibm.com/legal/copytrade.shtml.

References in this publication to IBM products or services do not imply that IBM intends to make them available in all countries in which IBM operates.

Any reference in this information to non-IBM Web sites are provided for convenience only and do not in any manner serve as an endorsement of those Web sites. The materials at those Web sites are not part of the materials for this IBM product and use of those Web sites is at your own risk.

Endnotes

1 Judith Samuelson *A Critical Mass for the Long Term* Harvard Business Review February 2006, 62-63

2 Thomas H. Davenport, Marius Leibold and Sven Voelpel *Strategic Management in the Innovation Economy* Publicis Corporate Publishing and Wiley-VCH Verlag GmBH, Erlangen, 2006, 25

3 Thomas H. Davenport, Marius Leibold and Sven Voelpel *Strategic Management in the Innovation Economy* Publicis Corporate Publishing and Wiley-VCH Verlag GmBH, Erlangen, 2006, 16

4 Gary Hamel Strategy *Decay and the Challenge of Creating New Wealth* Strategos Institute, March 1999

5 Keith Leslie, Mark A. Loch and William Scheninger *Managing your organization by the evidence* McKinsey Quarterly 2006 Number 3

6 *Leadership instead of budgeting* (Translation by Franz Röösli of an Interview held by Prof. Gaitanides of Zfo Magazine with Mr. Stadelmann, CFO UBS WM&BB in ZfO 06/05)

IML14145CAEN