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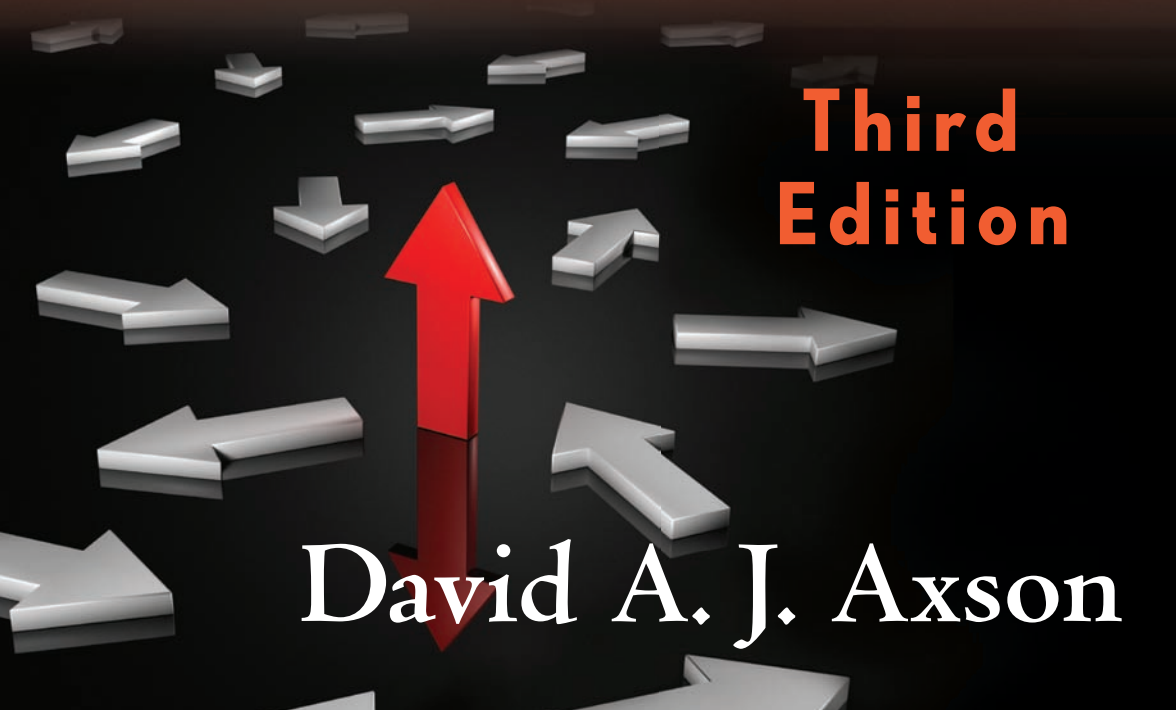
BEST PRACTICES IN PLANNING AND PERFORMANCE MANAGEMENT

RADICALLY RETHINKING MANAGEMENT FOR A VOLATILE WORLD



Third Edition

David A. J. Axson

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To Mum and Dad: I miss you both

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PART TWO
BEST PRACTICES

Preface to the First Edition

This book has its origins in my father's study during the late 1970s. Dad had bought one of the first Commodore Pet computers to be sold in the U.K. and was writing BASIC programs to automate the financial reporting for the family furniture business. I was his data entry clerk.

After staying up into the early hours of the morning writing programs and laboriously copying them onto cassette tapes—this being before the days of the first floppy disk—I would help him key in the day's transactions before leaving for school. Over the next few months, we developed a full accounting, budgeting, and financial reporting system for the business—complete with customer database, inventory management system, and scorecard reporting system. We did not know then that this is what these features would come to be called, but they worked. Thus was my interest sparked in planning, management reporting, and the application of computers to business.

Dad sold the family business soon after and moved into computing full time; I left for university to study accounting and computer science. Twenty-five years later, I feel ready to document what I have learned in my journey through the application of technology to business planning and management reporting processes. Starting with my first job at Lloyds Bank (now Lloyds TSB) in London, followed by 18 years in consulting and moving on to research this book, information has been my career. Throughout that time, one of Dad's earliest pieces of advice to me has remained one of my guiding principles.

One night I was sitting in his study and we were talking about the potential of computers to change the world. I am sure Steve Jobs and Steve Wozniak and Bill Gates and Paul Allen were having similar conversations around the same time. As Dad and I discussed the potential applications to which computers could be put, Dad commented, ''The real power of computers will only be realized when the user needs to know nothing about them in order to find them useful.'' He was right then and he is still right now. The full potential of computer technology to add value to life in general, and planning and management reporting in particular, will only be realized when the user does not need to have any computer knowledge at all to benefit.

Dad passed away in 1999. I hope this book follows his mantra of keeping it simple by explaining complex things in words people can easily understand.

David A. J. Axson
March 2003

Preface to the Third Edition

The second edition of this book was published in early 2007, just as the first signs of a housing bubble were emerging in the United States. By early 2008, Bear Stearns had failed and signs of further stress in the housing market were clear. However, many commentators were still predicting that the fallout would be limited. Then came September 15, 2008, and the collapse of Lehman Brothers; suddenly all bets were off. I was in Prague that day, and as I observed the beginning of the near collapse of the global financial system, I was conflicted. On one hand, I, along with everyone else, saw the value of my investments plummeting, while on the other hand, here was incontrovertible proof that the management processes upon which organizations have relied for more than half a century were totally broken. In this edition I have updated all the best practices to reflect the learnings from the ''crash,'' or was it the ''crunch''? In almost all cases, the argument for best practices has simply been made stronger. Each of the best practice chapters (5 through 10) now contains a new section, ''Lessons for a Volatile World,'' which summarizes the key lessons managers should take away from the events of 2007 to 2009. Use this book as a road map for driving fundamental change so that we will all be better prepared next time.

David A. J. Axson
January 2010

Acknowledgments

Numerous people contributed their knowledge and insight to the ideas developed in this book. One of the joys of consulting is that you have the opportunity to learn from many very smart people, both colleagues and clients. Thanks are owed to many current and former clients and colleagues who helped expand my thinking and challenge my stubbornness, including Doug Barton, Pete Brewer, Reuben Chaudhury, Carolynne Cox, Robert Craven, Stu Dressler, Mary Driscoll, Lou Eyermann, Mike Geltzeiler, Christine Gattenio, Greg Hackett, Jeff Holker and the IBM Cognos Innovation Center, Greg Horn, Ian Hunt, Alex Jaime, Art Krause, Mark Krueger, Vinnie Mirchandani, Tim Murphy, Dave Paul, Steve Player and the team at the Beyond Budgeting Roundtable, Jeff Rosengard, Rick Roth, Lawrence Serven, Holly Snyder, Helene Uhlfelder, Mike Upchurch, Nic Walsh, and Liz Wenzel.

Most of all I want to thank my family. My wife, Donna, proofread much of this book and offered constant support and encouragement. As always, she was the principal reason I was able to get the job done. My two children, Eleanor and James, provided much light relief as I struggled with various sections. Their smiles and love ensured I kept my priorities right.

Best Practices in Planning and Performance Management

Introduction

There is no doubt that that we live in the Information Age. A typical weekday edition of the *New York Times* contains more information than the average person was likely to come across in a lifetime in seventeenth-century England. Consider how the average manager feels when asked to develop plans, build budgets, report progress, and make decisions in response to today's increasingly competitive, fast-paced, and volatile environment. Traditional planning and management reporting processes are simply too slow, too detailed, and too disconnected for today's competitive world. Managers are seeking new decision-making processes and tools that will enable them to shorten the cycle time to make and implement a decision.

This book summarizes the current state of the art with respect to best practices for business performance management or performance management, as I shall refer to the topic going forward. Best practices have been the subject of much discussion in recent years, and a growing body of knowledge has emerged that purports to define best practices and quantify their value to an organization. A lot of anecdotal evidence links best practice application to improved performance. This book seeks to establish a framework for identifying and implementing best practices in performance management.

The underpinning of the research and analysis contained in this book is my work over the last 25 years with over 250 different companies: first as a consultant with Deloitte and A.T. Kearney in London, then as a cofounder of The Hackett Group, as head of corporate planning at Bank of America, and now as president of my own firm, the Sonax Group.

This book illustrates how leading companies are rethinking the way they make and implement decisions. The aim is to provide a practical guide to managers and students of business on the processes and tools that can be used to consistently make and execute better decisions faster.

Part One makes the case for a radical change in the way managers manage performance. Chapter 1 explains the need for effective performance management in today's fast-paced world. Chapter 2 explores why many of the processes that organizations rely on today are completely unsuitable for the tasks. Chapter 3 provides a series of diagnostic tools and measures to help you size the improvement opportunity.

Part Two describes the principal best practices for each element of the performance management process. Chapter 4 describes the approach for putting best practices into context and provides a brief review of the current state of the art. Chapters 5 through 10 describe best practices for strategic planning, tactical and financial planning, management reporting, forecasting, risk management, and technology respectively. In this third edition a new section entitled "Lessons for a Volatile World" has been added to each chapter in Part Two. These sections summarize

the key lessons managers should take away from the tumultuous economic events of 2008 and 2009.

Part Three provides insights into the steps required to design a best practice–inspired process that is right for your organization (Chapter 11) and to understand the critical success factors for implementation (Chapter 12) and the importance of effective leadership (Chapter 13). Chapter 14 offers my own predictions for the future evolution of performance management updated for events of the last few years.

I have tried to use terms consistently throughout the book—not always an easy task. I have used the term *performance management* as shorthand for business performance management throughout. The terms *financial planning* and *budgeting* are used interchangeably since no adequate definition of the difference exists. Similarly treated are the terms *organization, business, company*, and *firm*, and the terms *user* and *customer* when describing the recipients of management information. Overall, I have tried to use the most descriptive term for the context.

This is a book for anyone who has questioned the value of the budget process, been frustrated at the inability to get good information quickly, wondered why so much time is spent developing forecasts that are always wrong, or been angered by the repeated failure of technology to deliver on its promises.

Part One

Why Performance Management Matters

Chapter 1

Traditional Management Processes Are Obsolete

Change is inevitable in a progressive country. Change is constant.

—Benjamin Disraeli

If anyone had any doubts that traditional management practices such as complex multiyear strategic plans, detailed annual budgets, quarterly forecasts, and monthly management reports were obsolete, they were blown away on September 15, 2008. Much as Netscape's initial public offering on August 9, 1995, marked the dawn of the Internet age, Lehman Brothers' bankruptcy filing put the final nail in the coffin of calendar-based, accounting-driven performance management. Managers must now operate in a world of unprecedented complexity, volatility, uncertainty, and risk. Static management processes based on historic data simply do not work anymore. The facts speak for themselves. How many strategies, plans, budgets, or forecasts that were crafted with such care in 2007 assumed that:

- Oil prices would rise from $45 a barrel to a peak of $147 before collapsing to $35?
- U.S. automotive sales would fall from an annualized rate of 16 million in 2007 to less than 10 million one year later?
- The Dow Jones index would lose 54 percent of its value, from 14,164 on October 9, 2007 to 6,547 on March 9, 2009?
- The $/£ exchange rate moved from $1.35 in March 2008 to $2.07 in January 2009 before falling back to $1.66 in July 2009?
- The H1N1 virus would move from a minor flu outbreak in northern Mexico to a global pandemic in six weeks?

We live in an uncertain world and it isn't going to change anytime soon. Continued globalization and technological change, combined with the emergence of issues such as environmental sustainability and global terrorism, is changing forever the role of managers and, more important, the processes and tools needed to manage performance. Let's explore some of the major forces of change in more detail.

BETTER-INFORMED CUSTOMERS

I was going to title this section ''Smarter Customers''; however, more knowledge does not always equate with more wisdom. Notwithstanding this nuance, there is no doubt that customers have access to better information than ever before when considering a purchasing decision.

Easy access to multiple sources of information and advice, not all of them good, has created customers who feel more confident, knowledgeable, and empowered. The balance of power between suppliers and customers has shifted irrevocably. For example, more than 80 percent of prospective car buyers research their purchase online before entering the dealership: They compare product and pricing information, assess financing options, and check the value of their trade-in all before they ever step into the salesperson's lair. The Internet has become the first stop for those seeking the best airfares or searching for a new job. Despite the wealth of new information available to customers, more information does not necessarily mean better decision making. In fact, the ease of accessing vast quantities of not-always-reliable information is likely to increase the frequency of speculative bubbles. Part of the exuberance that accompanied both the dot-com bubble and the housing bubble can be attributed to the incessant media and Internet coverage of the near-certain fortunes to be made. Organizations need to understand the implications of dealing with a better-informed if not necessarily smarter customer base.

The Illusion of Competence

An interesting phenomenon presents a conundrum as companies seek to get ever closer to their customers. I call this the ''illusion of competence'' and define it as the aura of misplaced confidence resulting from the assimilation of too much free information or advice of questionable quality. It manifests itself when people gain so much new knowledge that they mistakenly believe that they are now experts.

The Internet has given this phenomenon a powerful stimulus. Large amounts of information can be accessed easily. Examples include people who buy something on eBay for more than they would have paid at the local store and boast about the great deal they got, or those who plunged into managing their own investments, gave up their real jobs to become day traders, and boasted of having ''got into Yahoo! at $106 or Ariba at $75.'' These are probably the same individuals who started suing their online brokers when the market crashed in late 2000 or entered the Las Vegas real estate market in late 2005. Simply because customers can access millions of pages of free information and compare and contrast thousands of different products from the comfort of their armchairs does not guarantee that they will be transformed from suckers to seers.

Regardless of whether more information makes one smarter or just more confused, there is no doubt that it is changing business. Organizations have unparalleled access to data about customers, suppliers, employees, and competitors that can provide managers with greater knowledge in order to make better

decisions. Purchasing managers are able to ascertain complete pricing information for any item before entering into negotiations with suppliers. A human resources manager can compare the salaries being offered for different positions to ensure that the organization remains competitive; of course, prospective employees can do the same. Throughout the organization, people have access to increasingly rich and varied information; those who can harness such intelligence can realize significant benefits, those that cannot will likely not survive.

CHANGING MARKET AND BUSINESS MODELS

For anyone seeking to understand today's rapidly changing markets, a look back to the Industrial Revolution can be enlightening. The Industrial Revolution was founded on three significant changes:

1. A series of technological innovations broke the relationship between human energy and productive capacity. Prior to the Industrial Revolution, farmers could be only as productive as their own capacity to harvest their crops, and weavers were limited by the amount of wool they could weave.
2. Rapid advances in transportation allowed raw materials to be moved from their point of origin to a different location for manufacture into a finished product. It is no coincidence that the Industrial Revolution first took hold in Great Britain, the country with the largest and most efficient shipping fleet in the world at the time.
3. New and different operating models, such as factories, were developed to fully leverage the advances in technology.

In a relatively short time, the main underpinning of economic activity moved from the farm to the factory, and the population moved from the countryside to the town. This shift from a largely rural society to one based in urban areas was the defining social characteristic of the Industrial Revolution and was driven by the need to concentrate labor to exploit the productive capacity unleashed by the new innovations of powered machinery.

The dominant organizing factor was colocation of all aspects of the production process in a series of logical steps. Vertical integration reached its zenith with Henry Ford's massive River Rouge plant just outside Detroit, Michigan. Set on 2,000 acres by the Rouge River, the plant, completed in 1927, was the largest single manufacturing complex in the United States. At its peak during World War II, it employed over 120,000 people. The plant was self-sufficient in all aspects of automobile production, from producing a continuous flow of iron ore and other raw materials to finished automobiles. The complex included dock facilities, blast furnaces, open-hearth steel mills, foundries, a rolling mill, metal stamping facilities, an engine plant, a glass manufacturing building, a tire plant, and a power house

supplying steam and electricity. However, the dominance of vertically integrated businesses was already beginning to wane even as Ford constructed his industrial age masterpiece. Organizations found that the capital and skill set requirements needed to sustain excellence in all aspects of the process were too great. It was easier and cheaper to outsource much of the design and manufacturing process.

By the dawn of the computer age, the main elements of an integrated supply chain from raw material extraction to delivery of the finished product to the customer were well established. Unfortunately, one downside of this process was the creation of a series of cumbersome, bureaucratic paper-based processes to move the information needed to sustain the production process. Documentation of orders, shipping notices, invoices, and payments grew at a rapid rate, triggering the creation of paper factories alongside the real factories in most large corporations. The computer was perfectly placed to address this challenge by automating much of the basic accounting and transaction processing activities. As electronic communications improved, networks facilitating electronic data interchange (EDI) attacked the flow of paper between organizations. Emergence of Internet-based e-commerce made these capabilities easier and cheaper, fueling rapid adoption by almost all organizations.

While physical goods and services remain important, information-based services comprise an increasing share of the economy. In 1991, capital spending in the United States on information technology ($112 billion) exceeded spending for production technology ($107 billion) for the first time.

Beyond basic transaction-processing applications, organizations increasingly began to use the same technologies to share other information, such as design documents and contract information. With the arrival of e-mail and the Internet, no exchange of information was out of bounds. No longer were organizations required physically to colocate all their people or operations. The level of flexibility was such that a company like Boeing could relocate its corporate headquarters from Seattle to Chicago, occupying its new facility less than five months after making the initial announcement in 2001. Philip Condit, then the company's chairman and chief executive, described the reason for moving as "to be in a location central to our operating units, customers and the financial community, but separate from our existing operations."[1]

Today, a call to a credit card company may be routed to a customer service agent in Des Moines, Dublin, or Delhi, and the computer systems may be running in Prague or Poona. Basic business rules are being redefined; new products and markets are being created. Who would have thought that eBay, essentially an automated flea market, could sustain a $30 billion market capitalization (up from $20 billion in 2002), Amazon $56 billion, and Google $170 billion (as of January 2010), or that General Motors, the largest company in the world for more than 30 years, would fall into bankruptcy? Such changes require ever more flexible performance management processes and demand new and different types of management information.

Technology is literally changing the physics of business. Barriers of geography and scale have been redefined. Booksellers do not need stores, telephone

companies do not need networks, manufacturers do not need factories, and film companies do not need film studios. Amazon did not need to establish a physical retail presence to compete with traditional booksellers. E*Trade did not need thousands of highly trained and highly compensated brokers to shake up the retail securities industry. Established players, such as Barnes & Noble and Merrill Lynch, were forced to respond. It is quite likely that we will see similar disruptions occur as advances in biotechnology and energy conservation create new markets while making others obsolete over the next few years.

Technology has enabled new players to enter markets with new and differentiated service offerings that have had a major impact on the traditional players. Companies are creating new products and services and inventing new ways to interact with current and prospective customers. Nike has created a $20 billion business and a very powerful brand based almost exclusively around design and marketing. Others, such as Apple and Cisco, have developed very successful product businesses while owning little manufacturing capacity.

Changing Market Boundaries or Arbitraging Harry Potter

In the summer of 1999, the third book in the hugely successful Harry Potter series written by English author J. K. Rowling was published. The launch of *Harry Potter and the Prisoner of Azkaban* was scheduled to follow a fairly typical rollout plan. To manage the associated advertising and promotional campaigns, the publication dates in each market were to be staggered throughout the summer in much the same way as for the opening of a new film. The initial release was to be in England, the author's home country, followed a few weeks later by release in the United States. Traditionally, this process had worked well, but this time things were very different.

The Harry Potter series had become a publishing phenomenon, doing for children's fantasy what John Grisham did for the courtroom and Stephen King did for the horror story. The level of interest in the new book was huge. CNN ran stories about the new book's publication; bookstores scheduled midnight openings so that eager readers could be first to snare their copies of the book. The hype, itself a function of the increasing global and instantaneous nature of communications, was unprecedented. There was also another crucial ingredient: A new medium was available—the online bookseller. What followed was a sequence of events that would have profound implications for the way new products were brought to market in the future.

Back in 1998, Amazon.com, the pioneering Internet retailer, launched a U.K. service, Amazon.co.uk, following its acquisition of online bookseller Bookpages. The difference with most other expansions was that in this case, now anyone in the world who had a computer and Internet connection could access Amazon's new U.K. web site. The impending launch of *Harry Potter and the Prisoner of Azkaban* presented a unique opportunity. Devoted fans as well as some entrepreneurial individuals quickly logged on to Amazon.co.uk and ordered the new book. Soon there was a flourishing gray market in the United States for copies of the book. Many people were prepared to pay three, four, or even five times the cover price to secure a copy before the official U.S. publication date.

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Technology had decimated the traditional definition of a market and forever altered the planning assumptions associated with launching new products.

By the time the fourth book in the series, *Harry Potter and the Goblet of Fire*, was ready for publication in July 2000, the lesson had been learned. There was a simultaneous launch across the globe. Notwithstanding the logistical challenges of this launch, the hype was even greater. Television cameras covered the unique publishing event, and the launch was the most successful yet seen, only to be surpassed by the launch of the final three books in the series.

An organization's performance management processes must address the dual effects of simultaneously achieving much tighter integration up and down the supply chain combined with the effects of globalization and its impact on redefining markets. The need for timely, accurate information is much greater yet the organization's ability to mandate its provision is weakened. Similarly, planning is no longer an internal process; it requires the participation and collaboration of numerous players, some of which also may be doing significant business with a firm's biggest competitors. It does not matter how many personal computers Dell manages to sell if its suppliers are unable to supply enough parts to meet the demand.

STRUCTURAL CHANGE IN THE ECONOMICS OF BUSINESS

The 1970s were a bleak time for the traditional stalwarts of the Western economy. The three-pronged attack of sky-high oil prices, rising inflation, and aggressive competition from fast-growing, lower-cost Asian economies decimated whole segments of the North American and European economies. Some segments, such as consumer electronics, textiles, and shipbuilding, effectively disappeared. Others, such as iron and steel, automotive, and many manufacturing segments, were forever changed. In the space of a single decade, much of the foundation on which the Industrial Revolution was built was dismantled. If there was a positive effect of this brutal transformation, it was the increased focus on all aspects of productivity, quality, and cost management that took hold as management recognized that operational efficiency was a prerequisite for survival, let alone growth. Even successful companies were forced through a radical transformation. Exhibit 1.1 shows that, in 1980, General Electric derived 85 percent of its revenue from manufacturing; by 2000, this had been reduced to 30 percent, even as revenues grew from $25 billion to $125 billion.

During the 1980s, the manufacturing sector led the way in realizing productivity gains as it fought for survival in the face of intense global competition. Process innovations using tools such as total quality management (TQM), outsourcing, and just-in-time (JIT) manufacturing drove significant change and productivity improvement. The results were impressive—between 1981 and 1991, manufacturing