Innovation in Action Series
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The risk-based early warning system

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The risks and costs of compliance may be on the cover of every business finance magazine. But David Axson and Greg Hackett see a greater menace for CFOs and Controllers.

It's the future.

This is the second in a series of six articles by Axson and Hackett. They are establishing a new agenda for finance—an agenda that finishes the job started 15 years ago when forward-looking finance executives sought to transform finance from low-value 'bean counters' to value-added business partners.

In the first article, Axson and Hackett made a case for change with a wake-up call to today's finance leaders. In this second article, they make the case for finance establishing an effective risk-based, early-warning system for the company.

Who needs to watch the horizon for emerging risks? Who has the ability to change course to meet the challenge? Finance is the answer in both cases.

I'm pleased to present such provocative thinking as part of the IBM Cognos Innovation Center for Performance Management. Our member organizations share a belief that business as usual is not an option, if you want to improve performance dramatically.

David Axson and Greg Hackett are advisors to the Innovation Center. They also are unflinching advocates for innovation in business management practices. Both question the effectiveness of the status quo and urge companies toward better ways of doing business.

Read on as David and Greg make the case for committing more than a passing glance at the future, especially when the competition is consumed by the past.

Jeff Holker
Associate Vice President
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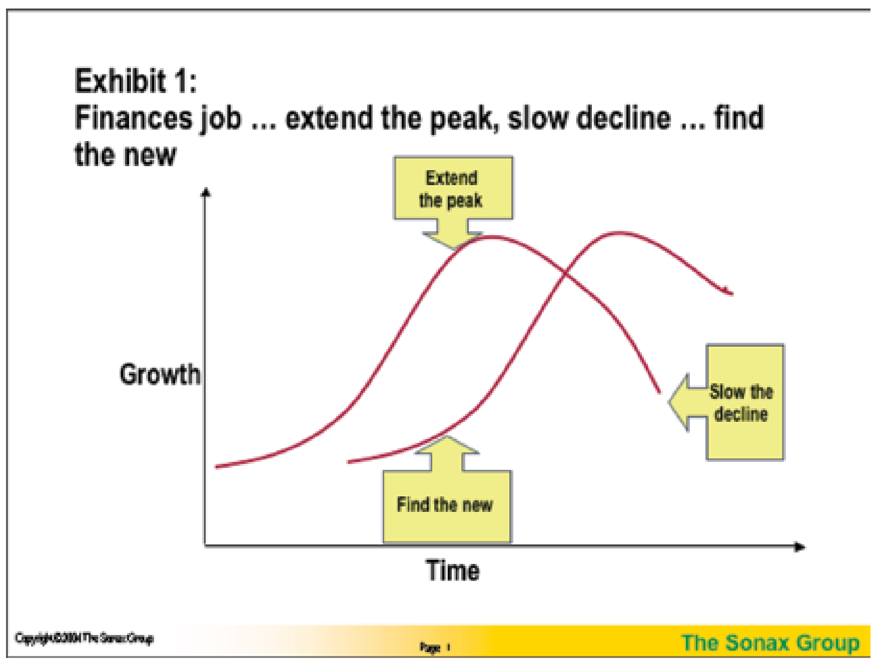
Finance and the emergent management model

In today's crusade for corporate survival, the finance function should be leading the organization through the shifting sands of uncertainty, volatility and complexity. The value-added role for finance is not in achieving marginal improvements in its own productivity, but in helping the organization to extend the life of a flagging business, to lessen the steepness of a decline or to seek new opportunities that can fill a void. (See Exhibit 1.)



A new management model is needed to do so, involving an understanding of market risk, the development of dynamic planning and decision-making processes and the maintenance of operational control in the face of continuous turmoil.

Virtually everything must change. To get started, finance should call a halt to all incremental process improvement efforts and turn to outsourcing for all transaction processing and administrative work. These actions were addressed in the first IBM Cognos "Innovation in Action" article in our series.

Next in this crucial undertaking, companies desiring to ensure the longest survival must

- Establish a risk-based early-warning system to recognize major threatening trends that take years to emerge, assess the degree of exposure to the business and enable managers to act early and decisively.

- Radically refocus performance reporting and analysis on key relationships and linkages; rebalance measures in terms of leading and lagging, internal and external information.

- Replace the annual planning process with a repeatable, short-cycle-time, tactic-focused process that takes less effort and time and yields better results.

- Recapture intuition as a factor in decision-making, fostering dialogue, debate and discovery to develop meaningful scenarios, create practical action plans and identify the first signs of flawed decision-making.

Establish a risk-based early warning system

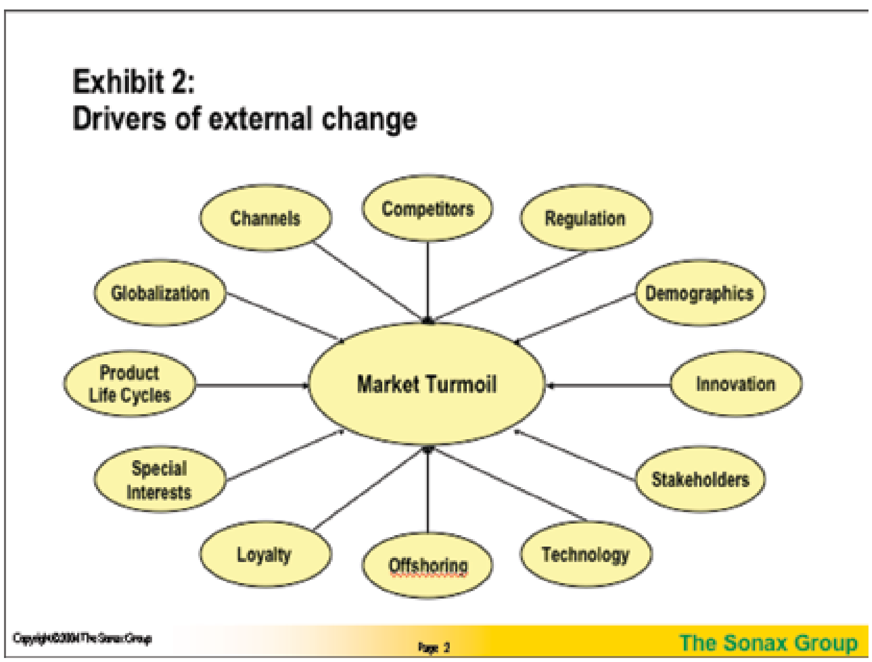
Very often, companies stagnate, decline or die because they minimize or miss profound changes. No one department or function is responsible for observing external and internal risk factors holistically to assess their implications on the health of the company.

Finance must take the lead in establishing a risk-based early warning system for the corporation. Finance should become the eyes on the outside of the corporation—as well as the inside—with radar up, scanning the horizons for threats and opportunities.

Issues emerge as pressure points over decades. Then they tend to behave like dominoes, cascading in causal relationships that rapidly affect multiple organizations. Consider the following examples:

- The serial decline in U.S. manufacturing during the 1970s and 1980s in the face of lower-cost foreign competition
- The demise of numerous mini-computer makers in the wake of the rise of the Wintel PC
- The rise of special-interest attacks around sensitive issues such as foreign child labor, employment discrimination and offshoring
- Regulatory assaults of the like perpetrated by Eliot Spitzer that have roiled the securities, mutual fund and insurance industries in rapid succession

To prepare for and respond to such threats, finance needs to be able to identify trends and to determine materiality and probability. A starting point is to analyze drivers of external change and determine how they affect the organization, such as demographics, technology, globalization, channels, competitors and regulation. (See Exhibit 2.)



With an examination of the key external change drivers in hand, finance first should assess what the company already knows. Information in silos throughout the corporation should be ferreted out and amassed. Using new technologies that enable the aggregation and organization of data from multiple sources can speed this process greatly. Data gathered in one part of the business could prove invaluable to another.

But to be at all effective in establishing a risk-based early-warning system, companies must get beyond the data in the ERP system. In parallel with the internal data assessment, finance must look outside, seeking those trends or events that signal opportunity or threat.

With internal data assembled and external inquiry under way, finance can begin to identify gaps in the company's intelligence and proceed to fill them. The emerging picture should then be circulated throughout the company, with orders to begin thinking about how to respond and embed the responses in business plans.

A set of risk factors will emerge that requires monitoring. Measurement could be systematic or discrete. Periodic research might be commissioned, or there could be event-triggered reviews. The point is to identify leading indicators and sources of data relative to positive or negative trends regarding a corporation's key risk factors. These leading indicators can then be programmed into the organization's performance management system to provide early warning as a prompt for management action.

Running a risk-based early-warning system is a fulltime activity. Identifying the threats is relatively easy, but getting the organization to take the predictions seriously is harder. There will be more effort on changing what's inside than on the changes that are outside. Finance must educate the company on the emerging threats and what might happen. The challenge is to not just scan the horizon, but to transmit the information across the company and to drive through to planning and action and realignment of the culture. Again, appropriate use of technology to filter and focus this information can promote early recognition and action.

To ensure full leverage of data regarding risk—and to eliminate the silos of external intelligence—finance will establish an enterprise risk-management team. This team is not staffed by accountants. A small team of analysts is supported by people with a range of skills sets— futurists, economists, sociologists, anthropologists, former management consultants and the like—with the requisite skills and expertise predicated on the factors that most threaten a company. A corporation might begin with an expert in changing demographics, for example, if that is a chief area of concern. The risk management team will identify and monitor trends, build and maintain the overall risk profile and, more critically, ensure risk is factored into all decision-making, collate and disseminate information and educate the organization.

Finance will be leaders not only in conveying new information that anticipates the future, but also in advising senior management, redefining the decision culture, reallocating resources and driving change. Such an effort is vital to corporate survival, permitting companies to either stay in the business and get ready for future trends— or to prepare to exit a business at the appropriate time. A risk-based early-warning system buys time to change direction.

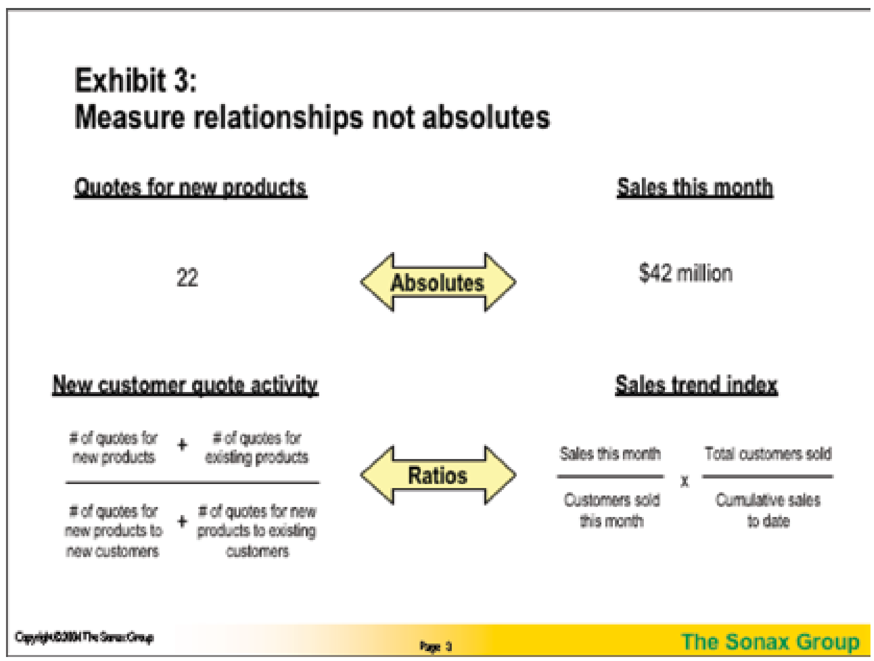
Radically refocus performance reporting and analysis

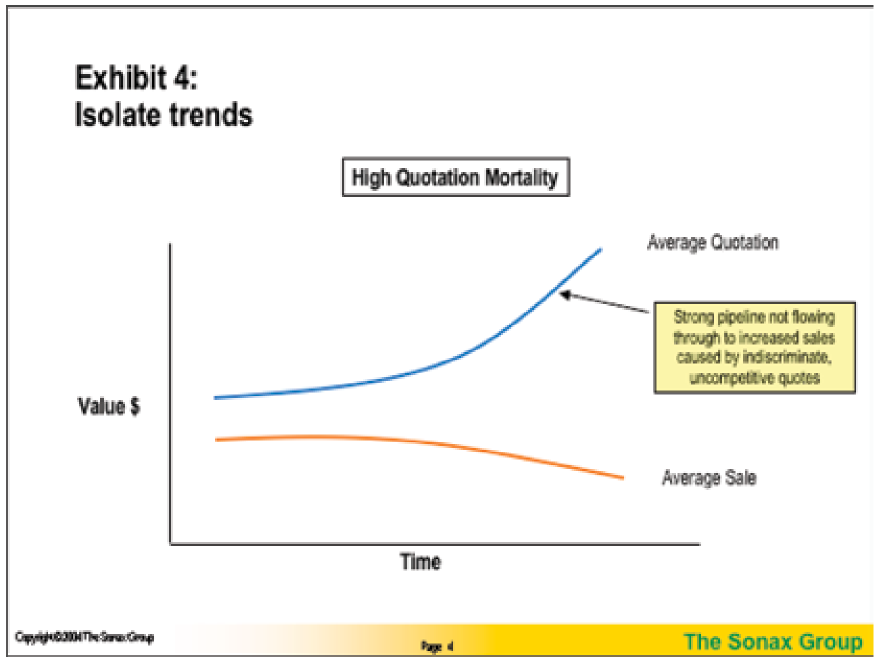
The stagnation and decline of businesses promises to accelerate if companies persist in prosecuting work with 20th-century practices, such as how they presently measure, report and analyze performance. Finance must take the lead in radically refocusing performance reporting and analysis on relationships and linkages. Further, measures must be rebalanced in terms of leading and lagging and internal and external information.

Less is more. Companies should be more selective regarding performance measures. Measurement should be based upon exceptions, driven by materiality, triggered by events and anticipatory of the future effects of current events and trends, all filtered by technology. Only actionable data should be reviewed, and reporting should be driven by the data that is needed, not simply what can be obtained from systems.

Business information needs tend to be finite. There is a defined universe of measures of importance based around financials, markets, customers, operations, employees, suppliers, competitors, infrastructure, risk, projects and compliance. These measures provide a comprehensive framework for defining the key relationships and ratios that allow managers to understand performance and rapidly respond to opportunities and threats. Finance needs to refocus the organization on measures that are key to its operations and reduce the focus on single-point measures that offer little insight into the true drivers of performance.

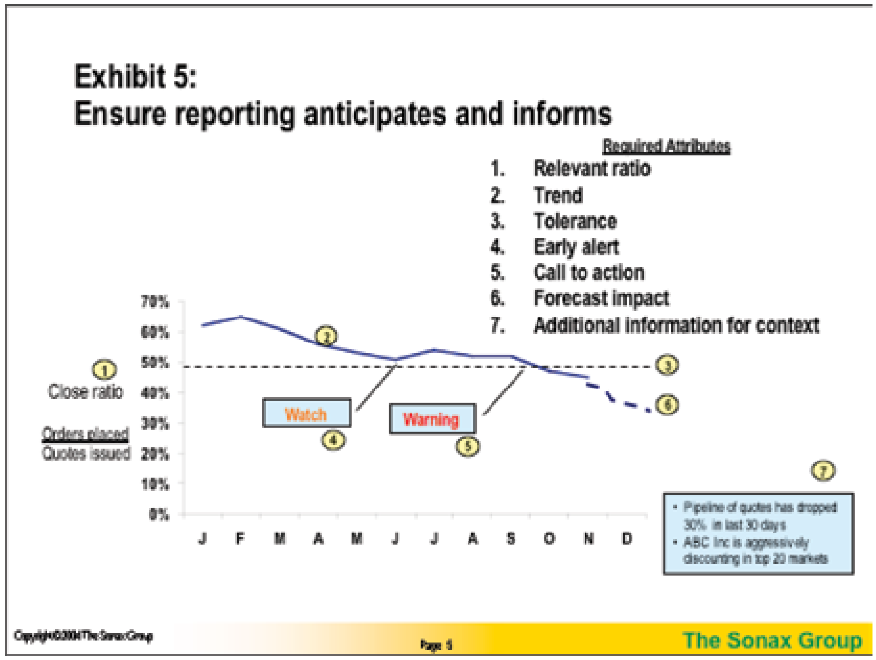
The secret is to abandon the reliance on absolutes. Recognize that a single data point cannot be a key performance indicator. Ratios are the solution, measuring linkages, relationships, interdependencies and trends. (See Exhibits 3 and 4.)





Finance should start by helping the organization define the critical business ratios— no more than 20— for the corporation, such as revenue growth relative to the growth of the market, or the relationship between changes in customer satisfaction and revenue per customer. These ratios will vary by company based upon the type of business, the company's organizational structure, the external environment, the life-cycle stage of each line of business and the chosen management model. Cascading these ratios throughout the organization, there should be no more than 10 key ratios per manager, and about 30 percent of these ratios should reflect external or market-based factors. Standard time-based reporting must transition to include reporting triggered by events, trends or tolerances.

Further, measures should be balanced between leading and lagging, internal and external. (See Exhibit 5.) The astute organization will test all reporting against seven measures of reporting value: relevance, trend, tolerance, early warning, call to action, forecast/projection and additional contextual information.



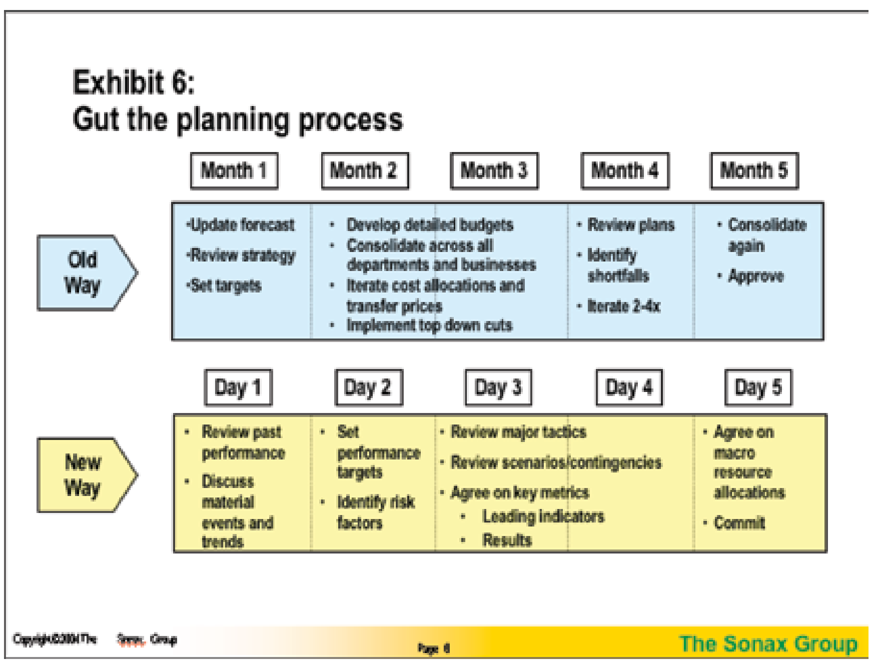
Technology plays a key role in refocusing performance reporting. Finance should develop vehicles for capturing, organizing and "Googlizing" unstructured data and integrating it into the reporting processes; technology should filter, select and disseminate the information. In addition, technology should be leveraged to eliminate all manual data collection, consolidation, reporting, dissemination, formatting and presentation. Time is thus freed for analysis, interpretation and discussion.

Gut the annual planning process

A vanguard manager must know each day not only where the organization has been, but where it is presently, what its destination is and how it will get there. This may be intuitively obvious. But one would never know it by looking at how most companies presently prosecute their planning cycles.

Typically, planning is a very painful, highly distracting, four- to six-month forced march fraught with tremendous political battles. People hate it, and it's not effective. And the result is a static tool, obsolete from its conception, and the longer it takes, the more likely it is to be wrong. Time to stop? No, time to start thinking of planning as a process that goes on continually, refreshed every day, the actual embodiment of the work of a manager.

To reach this state, the entire annual planning process as corporations know it today must be gutted. Annual planning becomes a method for setting performance targets, agreeing upon performance metrics and building shared commitment for performance. It is tactic-centric and embraces risk and uncertainty, it should be completed in about five days. (See Exhibit 6.)



In this new planning vision, action commences from the top, rather than the bottom, where it typically starts today. Performance management systems automatically generate a baseline business plan based upon past results, adjusted for predefined productivity and growth beliefs. Discussion ensues about material events and trends on the horizon that will affect the baseline, and appropriate performance targets are established. The focus then shifts not to building budgets, but to determining the major tactics, improvement efforts or new initiatives needed to achieve the performance targets. Against each major business/project, managers assess the probability and materiality of key risk factors and define not only the criteria for success, but also the exit/abandonment criteria that ensure failing initiatives do not continue to drain valuable resources. Leading indicators and results measures are agreed upon, as are macro resource allocations.

The targets should establish a bandwidth of desired performance, not achievement of a single number. Managers commit to tactics, actions and resources, rather than numbers. This significantly reduces the capacity for "sandbagging the numbers" and also establishes the basis for setting incentives.

Compensation target setting should be kept separate from the target setting for resource allocation. Compensation targets should be established based upon net change in performance combined with performance relative to a market or peer group comparison.

Rather than creating meaningless budgets that fail to account for changes in the level of business activity, standard departmental expenses are managed using key ratios and actual trends in spending, such as recruitment cost as a function of headcount added. Complex inter-company allocations or transfer prices for indirect costs are replaced with a flat tax, eliminating apportionment of internal chargebacks, which consumes vast amounts of time and creates zero shareholder value.

Once the tactical planning process is complete, it should be able to be constantly refreshed upon demand, with new or modified tactics commissioned within a week. Thus, the planning process is dynamic, continuous and inextricably linked to the ever-changing environment in which every organization must operate.

Recapture intuition in decision-making

Today's unwittingly outmoded managers follow a professional approach to decision-making – creating, executing and reporting on detailed action plans. The focus is on short-term results – the current month or quarter. Trends and their interrelationships are missed because the only data reported are results against plan. This approach presupposes that analytics are better than, as opposed to complementing, intuition. This bias has bred a generation of managers often void of experience and instinct and incapable of action without data.

Finance must inspire the recapture of intuition as a factor in decision-making, fostering dialogue, debate and discovery to develop meaningful scenarios, create practical action plans and identify the first signs of flawed choices.

With the newfound threat and performance information in hand, finance should promote dialogue around the information, encouraging the use of experience and intuition. Companies should collaborate to comprehend the "big picture," with time devoted to understanding risk and how initiatives might fail. Finance should guide the organization to ensure that the right amount of time is allocated to innovation, improvement and execution.

Financial analysts should be co-located with business partners. Analyst resources should be shifted away from spreadsheets and into dialogue, debate and discovery. Some 50 percent of analyst time should be allocated to direct interaction with peers and business partners. Analytics should inform intuition. Technology promises the power to deliver insight through applied logic, selectivity and monitoring of key relationships, which offer rich inputs to the decision- making discussion and drive not just better, but faster, decision-making.

Both staff and management should be educated on the process of collaborative decision-making. Time should be set aside for discovery and brainstorming. Unstructured analysis should be encouraged. Working sessions should be planned for senior management to better understand key external risk factors, debate materiality, potential impact and actions the organization should consider in response to each.

Summary

The end result is a re-energized culture. The company no longer takes success and continuity for granted, nor is blind to the effects of potentially adverse external trends. The acceptance of risk is greater, as failure is contemplated along with success. Intuition and dialogue are promoted, and change and speed are rewarded.

Finance has the proficiency and the power to bring about these changes. The task may seem daunting, but corporate prosperity—even mere corporate survival— is at stake. The next article in this series will discuss in greater detail how to develop a risk-based early-warning system.

About the authors

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About the Sonax Group

The Sonax Group is a consulting and advisory firm redefining business management practices. Established by David Axson and Greg Hackett, founders of the renowned benchmarking and finance transformation authority The Hackett Group, the firm works with executives to improve the effectiveness of their planning, performance management and decision-making processes, radically simplifying and refocusing them to achieve flexibility, agility, confidence and consistency.

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The IBM Cognos Innovation Center is dedicated to transforming routine performance management practices into "next practices" that help cut costs, minimize risk, streamline processes, boost productivity, enable rapid response to opportunity, and increase management visibility.

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