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Transforming performance management

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Experts around the world are arguing that organizations need to replace inflexible, costly, labor-intensive processes and procedures with more effective approaches to managing financial and operational performance. And many companies are climbing on board – sort of. On the one hand, they are implementing such things as shiny new dashboarding systems. But on the other, they're hanging on to relics of the past like annual budgets and spreadsheet-based management tools. Instead of simplifying, they're making things more complex. Instead of working smarter, they're working harder. And not seeing many of the benefits they'd hoped for.

I'm pleased to introduce a series of six articles by Jeremy Hope, Research Director of the Beyond Budgeting Roundtable. These papers will explain how organizations are using innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have smashed through many of the barriers that prevent the transition from business-as-usual to create – as Jeremy says – a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, the office of finance can drive enhanced productivity, performance, and profitability throughout the organization.

In this first article in our six-part series, Jeremy examines how organizations can transform their performance management systems and sets the stage for the articles that follow. He focuses especially on issues within the office of finance and reasons why finance needs both new approaches and new ways of thinking.

Jeremy Hope is an advisor to the IBM Cognos® Innovation Center for Performance Management. 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.

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Introduction

How good is your performance management system? Does it provide your senior executives with the early warning signals of poor results or leave them facing angry shareholders? Does it encourage managers to strive for maximum potential performance or reward them for negotiating "comfortable" targets and playing the political game? Does it ensure that all resources enhance rather than destroy shareholder value? Does it support a culture of local decision-making, openness and knowledge sharing, or leave managers feeling impotent and frustrated? And does it add value to all its users or just waste vast amounts of their time? A good performance management system is key to winning in the knowledge economy, yet most companies know that their existing systems were designed for a competitive era that is fast becoming a distant memory.

None of this is new. Most large organizations are engaged in a host of improvement initiatives from Six Sigma to balanced scorecards in a desperate effort to change their performance management models from a culture of compliance and control to a culture of learning and improvement. But where is the evidence of sustained success? And how is it that, after such a long period of management "enlightenment," so many organizations (despite the rhetoric of their leaders) remain trapped in a time-warp of command and control?

While there are no easy answers to these questions, there is one point that recurs time and again in conversations with managers. Instead of becoming simpler and more adaptive to change, organizations are becoming more complex and difficult to change. Where do all these new procedures, regulations, systems, and controls come from? How is it that for every new system we install (such as a balanced scorecard) we keep the old system in place (in this case, the annual budget)? We have been adding layers to the corporate onion instead of peeling them away. Instead of working smarter, people are working harder than ever. There is more pressure to perform, more stress, and less time for analysis and reflection.

This paper is the first in a series of six that examines how organizations can transform their performance management systems. It will set the scene for what follows. In particular it will look at the current problems facing the finance operation and why it needs to change not only its practices and processes but also its mindset.

Why performance management systems are failing their users

Most performance management systems were designed to support a "command and control" style of management and, not surprisingly, that's the job they still do today. But times have changed. Globalization, advanced technology, e-commerce, and increasingly fickle customers are all factors driving large organizations into a state of perpetual change. Organizations need to become more adaptive, and this must be supported by their performance management systems. But that is not happening fast enough. There is considerable evidence from surveys and anecdotal feedback that these systems are too complex, slow, and inflexible. And they provide their users with poor value and precious few improvement insights.

Systems are too complex. The average large organization wrestles with too many general ledgers and too many budgeting and reporting systems. By comparison, best-practice companies have standardized on a single platform. There is also too much detail and complexity. The average management report is far too long and contains thousands of data points, yet managers typically use only a fraction of the information contained in any report.[1] This complexity slows down month-end reporting and makes organizational change a nightmare for the finance department. Part of the reason for this level of detail is that local managers don't want to be caught out by their superiors if and when they ask detailed questions. Too many boardroom members demand answers to trivial questions about, for example, why this quarter's telephone account was higher than budget, when they should be more concerned with where the organization is heading and whether it is doing enough to create future value.

Information is too slow. One of the primary responsibilities of finance is to provide the board and operating managers with fast, relevant information that tells them where they are now and what the short-term future looks like. But most finance teams are unable to meet such demands. For the average company, monthly close times rose from an average of 5.2 days in 2003 to 5.5 days in 2004. It takes the average company an additional six days to provide monthly reports (that's 11 days after the month-end).[2] Managers are therefore in the dark for weeks on end.

Systems are inflexible. With reports taking so long, it is no wonder that most firms complain about inflexibility. Most front-line managers still follow the plan, no matter what is changing around them. The problem is that performance management systems are wired for control rather than fast response. One direct consequence of inflexibility is the creation of contingencies. The unspoken assumption is that the world is predictable and that the consequences of our actions are known. While everyone knows this is a fallacy, few organizations recognize it openly. The way to deal with this uncertainty is to build contingencies into targets and results. This leads to managing the numbers instead of the business.

Forecast quality is poor. Another problem is that it takes an average of 15 days to develop a forecast and the quality of these forecasts is often poor.[3] According to a 2004 survey, only 21 percent of executives thought that finance was any good at preparing forecasts (25 percent said they were hopeless).[4] The forecasting system is also too slow and limited in outlook. In most cases, forecasts are geared to "keeping on track" to meet the numbers rather than informing strategic reviews that go beyond the next fiscal year-end.[5] Consolidated forecasts take too long and often involve too many spreadsheets with variable methodologies and algorithms.

Decision support capabilities are inadequate. Operating managers need help with an expanding range of strategic responsibilities and decisions, but they are less than impressed with the decision support capabilities of their finance colleagues. Only 37 percent of senior executives believe that their own finance department does a good job of decision support (54 percent said it was average and nine percent said it was poor).[6] Nor, it seems, is finance much better at providing risk management support. Only 19 percent of executives believe their finance colleagues do a good job of managing risk.[7] Too much reliance is placed on keeping within budget guidelines and not enough support is focused on how risk and uncertainty affect decision-making. Clearly, the finance team has a long way to go to earn its place around the business development table.

Systems lead to dysfunctional behavior. The performance management process tends to start with negotiation over targets. But once these targets have been agreed upon, personal reputations (and sometimes financial bonuses) invariably rest on hitting them. This leads to dysfunctional behavior, since managers will do just about anything to meet their numbers. A purchasing manager given a target of reducing cost is likely to order in bulk or pay suppliers late, but has no responsibility for the poor quality of the products bought, the costs of high inventories, or the deteriorating relationships with suppliers. A pensions salesperson will sell those products that provide her with the highest commissions rather than those that meet the client's needs. A manager will spend what's in the budget – whether it is warranted or not – or risk losing those resources for the following year. Such behavioral problems are not caused by mischievous managers, nor are they isolated examples. They are systemic. That's why we need to transform the system as a whole.

A new vision for performance management

These pressures on the system are causing CFOs to think more deeply about their own roles as well as those of their finance teams. Many aspire to be business partners (a 2004 survey showed that 65 percent of senior finance executives want to be business partners within two years—more than double where they see themselves today[8]), but the vision of how to get there is anything but clear. One road is paved with more tools, systems, and projects, and is based on "fixing" identified problems (e.g., using a balanced scorecard to fix the "strategy problem" or a rolling forecast to fix the "forecasting problem"). But the failure rate is as high as 80 to 90 percent.[9] The problem is that these approaches increase complexity and workload and don't change command and control mindsets.

The other road is paved, not with slick solutions, but with clear and simple principles and practices that lead to the liberation of both the finance team and their internal customers. It involves simplifying everything they do and delivering effective decision support and performance insights that really help managers improve their results. This road takes us on a journey to an adaptive, lean, and ethical organization. The CFO can be its champion and, in some cases, even its leader. Gary Crittenden, CFO of American Express, articulated this vision in the following way: "An ideal finance function spends very little time on reconciliation and a minimal amount of time reporting on what has happened. Instead, a great organization spends the majority of its time trying to anticipate what's going to happen in the future, making sure the company's resources are allocated to the most important opportunities that it has, and to ensuring that the company operates with tight controls and great processes."[10]

The transformation journey

This transformation road is a tough one to follow because it challenges many of the finance team's accepted practices and systems. Problems must be recognized and the difficulties faced before the journey can begin. A good place to start is by understanding what transformation really means. The formula D x V x F > R describes the task well (D = dissatisfaction, V = vision, F = first steps, and R = resistance to change). It tells us that dissatisfaction, no matter how deep, is not enough on its own. There must also be a compelling vision of how the transformed organization will look and feel when we get there. But even these two together require a third partner. There has to be a clear understanding of the first steps along the journey to build credibility and thus take key people along. All three must be in evidence in sufficient strength to overcome the resistance to change.

In the five papers that follow this introduction, we will look a number of key issues that the CFO and the finance team must acknowledge and deal with to travel along this road successfully and transform the performance management system.

Target setting: Focus on medium-term stretch goals that drive continuous improvement. There is a pervasive view in finance that performance improvement can be driven and controlled by setting financial targets and then putting pressure on managers to meet them. This is one of the great illusions of modern management. Adaptive organizations have abandoned fixed targets. Instead, they set high expectations and devolve goal setting to front line teams that focus their energy and commitment on continuously improving against a stretch (medium-term) goal. The endgame is to be the best company in their sector, the best business unit in their region, division or company, and the best finance operation in their peer group either inside or outside the organization.

Performance evaluation: Base accountability on team performance with hindsight. Organizations cannot break free from the shackles of command and control management unless they also tackle the thorny issue of how manager performance is evaluated and rewarded. This is usually based on negotiated targets and invariably leads to gaming and unethical behavior. Adaptive organizations evaluate performance "with hindsight" rather than against a predetermined target: How well did a team perform compared with its peers? How well did they deal with the unpredictable events that actually happened? How well did they execute their strategy? How well did they invest for the future? It is answers to these questions that provide a framework for fair and effective performance evaluation.

Planning and forecasting: Use continuous planning and rolling forecasts to support adaptive management. Most organizations want to adapt rapidly to changing events, but find that they are handicapped because of fixed budgets and poor forecasts. Adaptive organizations are able to respond more rapidly by switching resources dynamically to meet new threats and opportunities supported by continuous planning cycles and rolling forecasts that enable managers to continuously look four to eight quarters ahead. Rolling forecasts, if well prepared, are the aggregate of "business-as- usual" forecasts (extrapolations of existing trends), all the action plans in progress, and all other plans in the pipeline. In many organizations, rolling forecasts are now taking over from budgets as the primary management tool.

Resource management: Manage resources dynamically to meet prevailing demand. Most firms allocate resources on the basis of budget contracts negotiated in advance rather than on current strategic priorities. Adaptive organizations make resources available and accessible to front line teams as and when required to support strategic initiatives. They manage operational resources by setting guidelines based on key metrics (such as a cost-to-income ratio) within which managers can operate. They release funds closer to the point of demand, enabling managers to take decisions better informed by the latest knowledge about likely outcomes and available alternatives. And they aim to manage investments as a balanced portfolio weeding out poor performers and constantly reprioritizing resources.

Governance and control: Focus risk management on multiple levers of control. Most organizations control performance against predetermined budgets and then take corrective action to ensure that performance remains "on track" to hit the target agreed. These control systems are reactive rather than proactive. Adaptive organizations are moving toward more strategic controls and risk management systems that thoroughly test key decisions before they are made, rather than just trying to control the outcomes. There is also a move toward more transparency, which leads to faster disclosure, more effective risk management, and more confidence in the numbers.

About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – *Transforming the Bottom Line* (1995) and *Competing in the Third Wave* (1997) with Tony Hope and *Beyond Budgeting* (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book *Reinventing the CFO* will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

About the BBRT

The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.

About the IBM Cognos Innovation Center for Performance Management

The IBM Cognos Innovation Center was established in North America, Europe and Asia Pacific 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 management, the Innovation Center partners with more than 3,000 IBM Cognos customers, academics, industry leaders, and others seeking to accelerate adoption, reduce risk, and maximize the impact of technology-enabled performance management practices.

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Endnotes

1 David A. J. Axson Best Practices in Planning and Management Reporting John Wiley & Sons, New Jersey, 2003

2 Ibid, 59

3 Ibid, 58

4 David M. Katz Is Finance Strategically Challenged? CFO Magazine www.cfo.com/article.cfm/3013927

5 Press release by Answerthink, March 20, 2002 www, answerthink.com/news_and_events/press_release

6 David M. Katz Is Finance Strategically Challenged? CFO Magazine www.cfo.com/article.cfm/3013927

7 Ibid.

8 CFO Magazine Staff Where the CFO Would Like to Be CFO Magazine June 22, 2004 www.cfo.com/article.cfm/3014471

9 According to the Hackett Group (2004 Book of Numbers), more than 80% of balanced scorecards are not providing full benefits. Average companies have 132 measures – that's nine times what is recommended by Kaplan and Norton

10 CFO Magazine Research Series CFOs: Driving Finance Transformation for the 21st Century 2002 www.cfoenterprises.com/research.shtml, p8

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