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How Performance Management Can Help You to Navigate through Turbulent Times

Paper #4 – Know Where Value is Created and Destroyed

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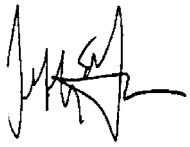
How does your company allocate capital? How do you know if you are putting your money in the right places in your organization? If your company is like other organizations, it's possible that a significant portion of capital is being spent on the wrong businesses, products and projects.

How can this be? The amount to invest in one business segment or another and the money to spend on new products and how to evaluate your strategic portfolio are almost life and death decisions for your company. Surely, every effort is being made to make sure that they're on the money.

Unfortunately, this is not the case. Companies waste as much as 50 percent of their capital on failed ventures and projects or trying to shore up divisions and sectors that are not profitable. Think of how much better off your company would be you if you were continuously aware of the brands, product lines, distribution channels, regions, branches and even individual customers that were strategic and profitable or if you could monitor individual investments and your whole investment portfolio at any time.

In this fourth in a series of five articles about how you can use performance management to weather and even thrive in turbulent economic times, Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, shows how viewing your organization with the eyes of a venture capitalist, enabling and encouraging as many new ventures as possible, can significantly increase growth, profitability and cash flow.

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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Imagine that you continuously knew which of your business segments such as brands, product lines, distribution channels, regions, branches and even individual customers were strategic and profitable (after charging all the costs of supporting them) and which should be terminated. Imagine that you had an effective, standardized way of approving new ventures and new projects that was applied at every level and thus encouraged teams to be innovative. And imagine you were able to track the performance of individual investments and the whole investment portfolio at any time. What would be the value of wasted resources you would save? And how much more innovation would you encourage?

Some time ago McKinsey reported that for the average large organization 25 percent of business segments added 75 percent of value, a further 50 percent added 25 percent of value, and 25 percent added no value at all. But finding which segments were in which category was not easy because the accounting system works vertically up and down the organization rather than horizontally across it. In other words, it is difficult to relate capital and support costs to independent business segments and over recent years this hasn't materially improved.

Another problem is that capital is too often allocated without effective scrutiny. Around 50 percent of investments would not pass a "strategic impact" test and only one in seven projects adds value beyond "staying even." Most organizations don't track investments effectively. A recent report concluded that as many as 75% of IT organizations had little oversight over their project portfolios and employed non-repeatable, chaotic planning processes.[1] The reality is that many organizations spend billions on the wrong businesses, products and projects. The amount of waste is huge.

How much to invest in one business or another, how much to invest in new products or new ventures, and how to evaluate performance across the strategic portfolio are questions that go to the core of effective corporate strategy. These are truly strategic choices that once made are *difficult or costly to reverse*.

The trouble is that these types of decisions are made by only a few people (often with their own "political" agendas) and their "batting average" is generally poor. While operating through only a handful of large divisions has long been an effective way to prepare managers for the top jobs and to limit the number of direct reports the CEO has to manage, these divisions make it difficult for managers to see clearly where value is actually created or destroyed. In these divisions, it is the division and functional heads that usually decide whether and where to place investment

funds and how to make key trade-offs between innovative (but longer-term) growth opportunities and short-term demands to meet the numbers. The evidence suggests a bias toward meeting short-term demands. One McKinsey study concluded that only 59 percent of financial executives would pursue a *positive* net present value if it meant missing quarterly earnings targets. Even worse, 78 percent said they would sacrifice value - in some cases a lot of value – in order to smooth earnings.[2] The outcome is a host of missed opportunities and a managerial blind spot where high performing units mask the performance of poor performing ones. The problem is that senior executives are often unaware that these decisions have been taken. The outcome is that there is little transparency in decision-making or value creation.

What you need to do differently

One way that leaders can overcome the traditional resource allocation system is to see the organization through the lens of a horizontal accountability map (Figure 1) and look to create hundreds of value centers around products and customer niches (we discussed this point in Paper #1). By making teams accountable for creating value and justifying their capital usage, firms are more likely to make better resource allocation decisions (and cut huge amounts of waste).

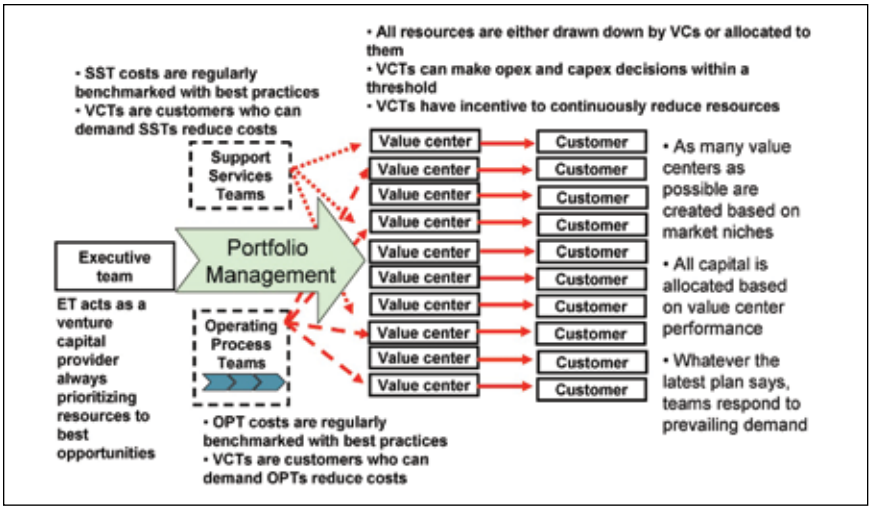

Figure 1. Leaders manage a portfolio of value centers

In one example, a large health care company analyzed one of its divisions by the type of disease to be treated, rather than by the classic functional structure of research, development, sales and production. This meant adding up all the products used to treat each disease, the specialized sales forces serving specialist professionals around the globe, and the development teams working on new medical devices. In another example, a European bank identified more than 50 value centers where it had once had nine divisions. Each center was built around related products, segments, or geographical boundaries. Examples included consumer finance, asset management for institutional clients such as pension funds, or wealth management for wealthy individuals.[3]

While leaders see their organizations as communities comprising of multiple teams that deliver customer value this doesn't mean wholesale restructuring, nor does it mean the disappearance of the hierarchy (although there is a lot less of it). It is the relationships and the information flows between levels and across the business that change.

Leaders such as Ohno (Toyota), Wallander (Handelsbanken), Iverson (Nucor Steel) and Kelleher (Southwest Airlines) all created hundreds of small teams with profit (or value) creating accountability. At Handelsbanken, each branch team is a profit center with the scope and authority to run its own business (there are around 600 profit centers). At Whole Foods Markets each store is made up of multiple teams (e.g., fresh fruit) that are accountable for their results and that have the authority to appoint their own team members. At Southwest, each "route" and each airport "station" is a team. At Nucor Steel there are only four layers of management between the CEO and the floor worker and only 66 people in the head office. Nucor Steel operates through hundreds of self-directed teams.[4] Each Toyota plant is full of workstation teams that are responsible for continuously improving their performance.

The aim is to give value center teams profit and loss responsibility as if each was a stand-alone business. Senior executives benefit by having more detail and understanding of where value is being created and destroyed (detail that was previously hidden in budgets and other performance reports). It also provides a platform for more value-based strategic discussions and improves both accountability and transparency throughout the organization. For example, if there are any cross-subsidies going on, these should become clear. The result is a better portfolio management system and more control of strategic resources. In effect, leaders need to see the investment portfolio through the lens of value centers and operate more like a venture capital company than a central banker. They should expect divisional leaders to constantly experiment and spawn new value centers.

While managing so many value centers might appear to increase the CEO's workload, the reverse is often the case. Focusing more on each value center actually increases transparency because both senior executives and value center managers find it easier to identify and monitor a few key performance indicators that drive performance improvement, as well as to make decisions in a more straightforward way. In essence, the CEO can use value centers to take out several management layers. Instead of aggregating plans and results into complex divisions and then spending lots of time understanding their performance, the CEO is able to take a larger number of more rapid, more insightful, and more value-based decisions at the value center level.

To facilitate these changes the management information system needs to be realigned around "horizontal" data flows that need to cope with, sometimes, hundreds of profit and loss accounts. It should also be able to show peer comparisons, KPIs, economic profit, trends, and forecasts.

Another requirement is to build standard processes for approving and tracking projects. When capital is rationed, many organizations use some sort of ranking criteria to choose investments. One large U.S. bank developed such a balanced ranking model for its Online Financial Services (OFS) business.[5] The executive team had identified three strategic platforms: (1) Attract and retain high potential value customers (2) increase revenue per customer and (3) reduce cost per

customer. The initiative identification process started by sorting initiatives into two categories: "strategic" and "business as usual." The team developed three criteria for approving a strategic initiative: (1) it helps OFS achieve a strategic objective (as listed on the balanced scorecard) (2) it builds a competitive advantage and (3) it builds a sustainable point of differentiation.

To qualify as strategic, an initiative had to score highly on each criterion (initiatives that were rated medium to high were considered to be "major" projects; initiatives that rated medium to low were considered to be "minor" projects and initiatives that rated low were considered only as "activities"). Once past the initial screening process, the team then segmented them into two groups: those that were function-specific and shorter-term, and those that were cross-functional, relatively expensive and longer-term. The team used three questions in this segmentation process: Does the initiative reallocate resources within other functional units? Does the initiative cost more than $500,000; and, Does the initiative take more than three months to implement? Only those initiatives that received a "yes" to *any one* of these questions would pass through this screen to the initiative ranking model. Of the complete list of over one hundred initiatives, only eleven survived the first two screens. At this stage the proponents of each project would be asked to prepare a more detailed business case proposal. As figure 2 shows, six criteria were used to rank initiatives and these were "weighted" according to importance:

Criteria	Definition	Weighting
Strategic importance	Fit with strategic platforms outlined in balanced scorecard	40%
Cost	Cost of implementing the initiative (from conception to deployment)	15%
NPV	Present value of net benefits (three year time horizon)	15%
Elapsed time	Implementation time period (from conception to deployment)	10%
Interdependencies	Degree to which the initiative is dependent upon other initiatives or other parties	10%
Risk/complexity to implement	Operational risk Technology risk	10%

Figure 2. Investment approval criteria at a large U.S. bank

Another company that has done this well is American Express. A number of years ago, American Express didn't have much of a clue how much of its discretionary spending was on worthwhile projects. Nor did it know if it was optimizing risk across its portfolio. Its investment initiatives were tracked on thousands of spreadsheets but no one could collate the whole picture. Each of its ten business units had its own funding projections for technology, sales, operations and marketing projects. Cost estimates for these projects were then compiled by each unit's finance department, which submitted the proposals. With around 7,000 investment initiatives in play at any one time and a total spend of $5 billion (representing around 30 percent of the total operating expense base), the potential wastage in the system was huge.

The problem was that business units didn't use the same methods to calculate returns. The Global Corporate Services group, which handles corporate card and travel customers, might use a 12 percent discount rate to calculate net present value on a project, while the Consumer and Small Business Services unit would use 6 percent. Other complications included unregulated version control, little accountability for financial projections and no easy way to get a corporate wide view of projects and their finances. "It was every group for itself," says Anand Sanwal, director of corporate finance at American Express. There were guidelines, but it was so easy to change things inadvertently or on purpose."[6]

The International Payment Services group was the first unit in American Express to take the initiative and built a prototype for what would eventually become the parent company's Investment Optimization System (IOS). The system puts American Express's global business units on an equal financial footing, with standardized models and assumptions, tighter version control and better analytics. Since it went online a number of years ago, the system has reallocated tens of millions of dollars between business units for more optimal investments. Because of the new system, when American Express detects an opportunity and they have funding, they can quickly move forward. In one year the company was able to invest 20 percent more funding over their base plan, which led to an 8 percent rise in new cards.

It is important to understand that most decisions are taken at a local level based on standard decision criteria. At the segment level there is an opportunity to trade-off lower performing funded investments to new opportunities. Managers now review performance monthly and these reviews link to and inform forecast updates. They also include competitor analyses and reviews of changes in the external environment. They identify and quantify emerging risks and opportunities and the impact on plans and investment decisions. Investments are focused at the total company level (not the business unit) and funds are released dynamically according to current forecast and improvement priorities instead of annually in advance. Monthly refreshes of key revenue and expense line item forecasts drive resource allocation decisions. Full forecasts are updated three times per year.

Resource decisions have moved to front line teams with the board (or an appointed sub-committee) in control of the strategic project portfolio and the prioritization of resources. This committee is constantly looking at rolling forecasts and releasing funds on the basis of capacity plans and strategic initiatives. This process tells them what funds they have available, how many funds are already committed, and what is left to release into the system. This approach has cut costs dramatically as capacity is not fixed months or years in advance based on unrealistic assumptions.

The investment optimization system includes all discretionary investments whether they be “capital” or “revenue” based. IOS is an ongoing process that utilizes data on financial returns, risk and strategic importance. It is a way of doing business and a way of thinking about investment decisions. It addresses the question: “How do we use available resources to improve future performance?” In essence, IOS is the process of allocating resources among various projects, functional groups (e.g., marketing, IT, operations, R&D etc) and/or business units. It is a way to increase enterprise flexibility by showing which items to fund if more resources become available and which items should be sacrificed if total funding must be reduced. Above all, it is enables executives to focus on value creation rather than budget variances.

Toyota is another company that has developed a smart approvals system. Alex Warren of the Toyota, Kentucky plant made this observation: "If you've got a project that is supposed to be fully implemented in a year, it seems to me that the typical American company will spend about three months on planning, then they'll begin to implement. But they'll encounter all sorts of problems after implementation, and they'll spend the rest of the year correcting them. However, given the same year-long project, Toyota will spend up to ten months planning, then implement in a small way – such as with pilot production – and be fully implemented at the end of the year, with virtually no remaining problems."[7] When Toyota purchased some land for a test track in Arizona the U.S. lawyer acting for them was amazed at how thorough they were. These were his comments after the deal: "Toyota stands out as the preeminent analyst of strategy and tactics. Nothing is assumed. Everything is verified. The goal is getting it right."[8]

At Toyota, the emphasis is on thorough preparation. If a decision fails to live up to expectations, then management will be tolerant, but if the preparation is sloppy then they will not. A likely reprimand will follow. There are five major elements in the Toyota decision-making process:[9]

1. Find out what's really going on
2. Understand the underlying causes that explain surface appearances – ask "Why?" five times
3. Consider alternative solutions and develop a convincing rationale for the one preferred
4. Build consensus within the team
5. Use simple, efficient methods of communication

Most companies write long proposals and memos to justify their case. This is not a learning process. It tells people why you have made a proposal that they should accept. Toyota has communication down to a fine art. All the information needed to make a complex decision is presented on one 11" x 17" piece of paper. It is called an A3 report and typically has seven boxes: current situation, proposal, benefits, plan, implementation, controls and time-line.[10]

Toyota passionately believes in consensus decision-making for larger decisions. This involves many signatures on the proposal sheet. On a new product design, for example, there could be as many as 100 people examine and sign the "K4" form. This might involve someone from administration who has little to do with development. The idea is to involve people with different perspectives.

Six implementation guidelines

1. **Create as many value centers as possible** (each with its own profit and loss account). These offer senior executives a more transparent view of where value is created and destroyed.

2. **Act as a venture capital company rather than a central banker.** Derive projects from strategy reviews and align resources according to the highest priority initiatives. Also keep dividing the organization into as many small value centers as possible creating more roles for entrepreneurial behavior.

3. **Reorganize the accounting and information system so that value center teams have fast access to full profit and loss information as well as key operational indicators.** Design insightful value center reports based, where appropriate, on economic profit (this allocates capital to each value center thus showing a clearer picture of value creation).

4. **Design a standard investment approvals process** that is common across the organization and can be monitored centrally (also re-think the investment approval criteria to support more innovative projects with "longer-term" returns). Use balanced and "weighted" approvals criteria including, for example, strategic impact, risk assessment, net present value, cost, timeframe and sustainability impact. Prioritize projects according to strategic impact and value creation. Prepare investment proposals thoroughly but implement them quickly. Spend around 80 percent of the time on preparation and 20 percent on execution (but execute flawlessly first time). Obtain consensus for big ticket decisions.

5. **Design and implement a portfolio management system** (one database) that enables the executive team to continuously examine risk and reward both at the individual project and portfolio levels. Actively manage the portfolio.

6. **Reward teams based on value creation relative to peers.** Design an evaluation and rewards scorecard that include (heavily weighted) criteria relating to value creation

Senior executives need to stop wasting huge amounts of capital. But to do this effectively they need to see the organization through the eyes of a venture capital provider and enable and encourage as many new ventures as possible. If the 50 percent of capital that is systematically wasted can be redeployed in growing businesses or even kept in the bank, the impact on growth, profitability and cash flow will be huge.

About the author

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

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Endnotes

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