

Transforming financial planning in small and medium sized companies

Dr. Peter Bunce

BBRT Director

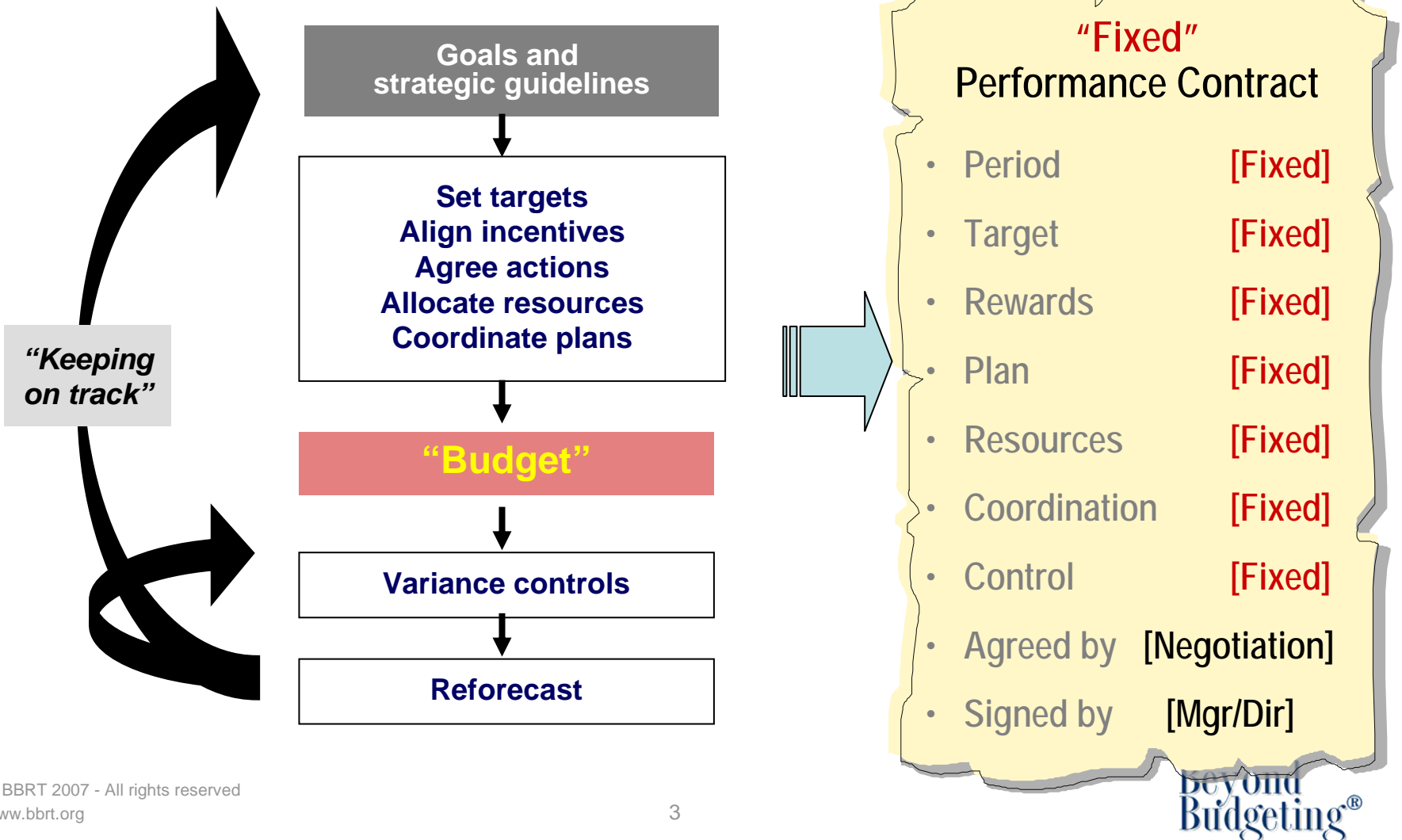
Stuttgarter Controller-Forum

18 September 2007

Agenda

- > The problem
- > Issues for SMEs
- > Manage through continuous planning cycles
- > Dangers of the fixed performance contract
- > Rolling forecasts as the primary management tool
- > Managing costs through trends
- > Making it work

How do you plan today?



Moving from industrial to innovation economy

INDUSTRIAL AGE

Steady, continuous change,
suppliers-in-charge

Predictable outlook

Limited choices

Long life cycles

High entry costs to markets

Physical resources drive value

Innovation is internal

INNOVATION AGE

Highly competitive, unpredictable,
customers-in-charge

Unpredictable outlook

Multiple choices

Short life cycles (not just products)

Fickle customers

Intangible resources drive value

Innovation is collaborative

New critical success factors

INNOVATION AGE

Highly competitive, unpredictable,
customers-in-charge

Discontinuous change

Short life cycles

Falling prices

Fickle customers

Choosy employees

Transparency

Critical Success Factors (CSFs)

All are important today

Fast response

Innovation

Operational excellence

Customer intimacy

Best people/teamwork

Ethical behaviour

The traditional model is misaligned with them

CSFs

- **Fast response**
- **Innovation**
- **Operational excellence**
- **Customer intimacy**
- **Best team**
- **Ethical behaviour**

- **Value creation**

Misalignment examples

- **Annual** planning process retards it
- **Centralized** bureaucracy stifles it
- **'Spend it or lose it'** mentality fights it
- **Short term** targets prevent it
- **Extrinsic** 'motivators' undermine it
- **Dysfunctional**, even unethical behaviour conflicts with it

- **Inferior** financial results

When pressure is applied, misalignment gets worse

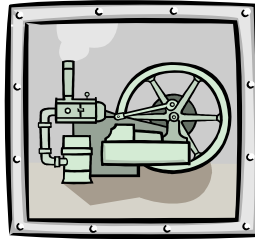
The problems of growing bigger



Creeping Bureaucracy

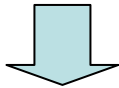
Large company vs. entrepreneurial

Organization as obedient machine



ORGANIZATION MODEL

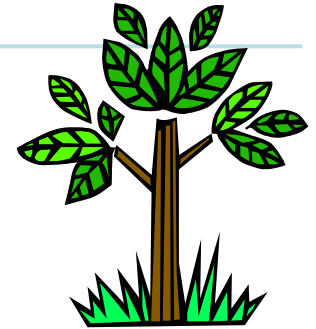
- Organization is a collection of replaceable parts (parts determine performance of whole)
- Organizations comprise of 'cause-and-effect' relationships that are predictable



MANAGEMENT MODEL

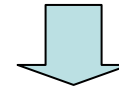
- Central planning, coordination and control
- Tools (eg BSC/CRM) to drive actions for innovation and improvement
- More targets, incentives & measures to control actions

Organization as living system



ORGANIZATION MODEL

- Organization is a holistic system (whole system determines performance)
- Organizations are webs of relationships that are unpredictable



MANAGEMENT MODEL

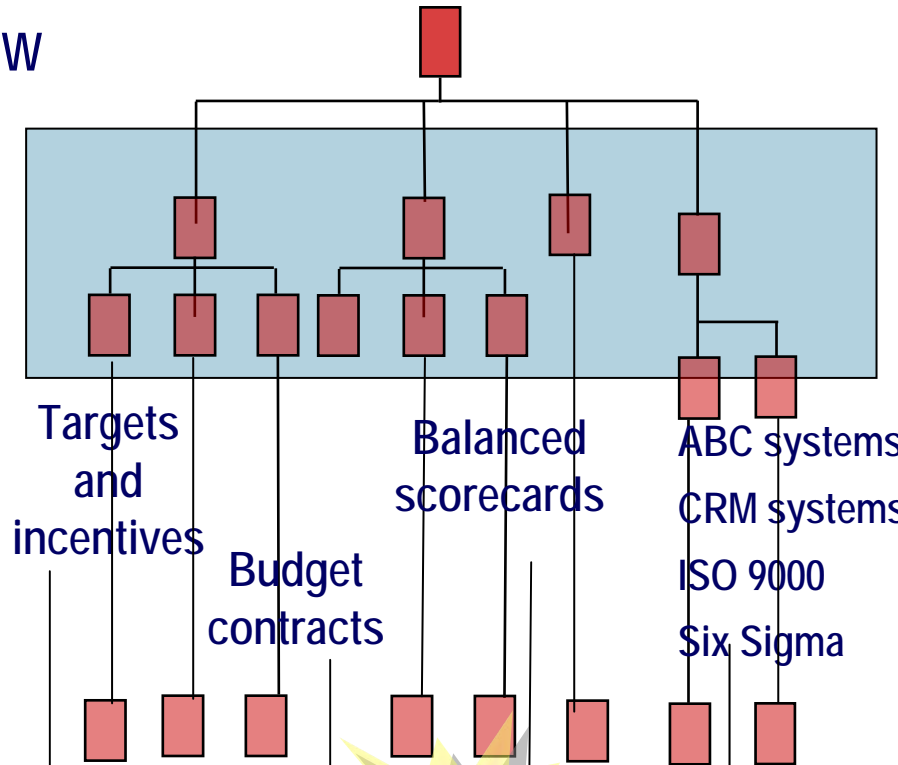
- Self-managed teams that can innovate and respond
- Freedom (and information) for teams to take action to continuously improve
- Self-regulation (with high-level monitoring) to enable innovation & response

The SME challenge – Avoiding the management factory

INDUSTRIAL AGE VIEW

The Management Factory

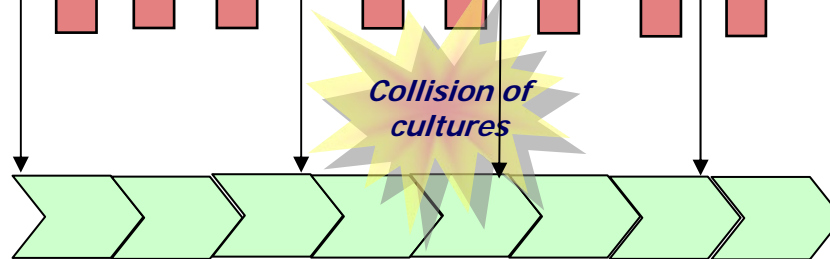
10-20% of costs



INNOVATION AGE VIEW

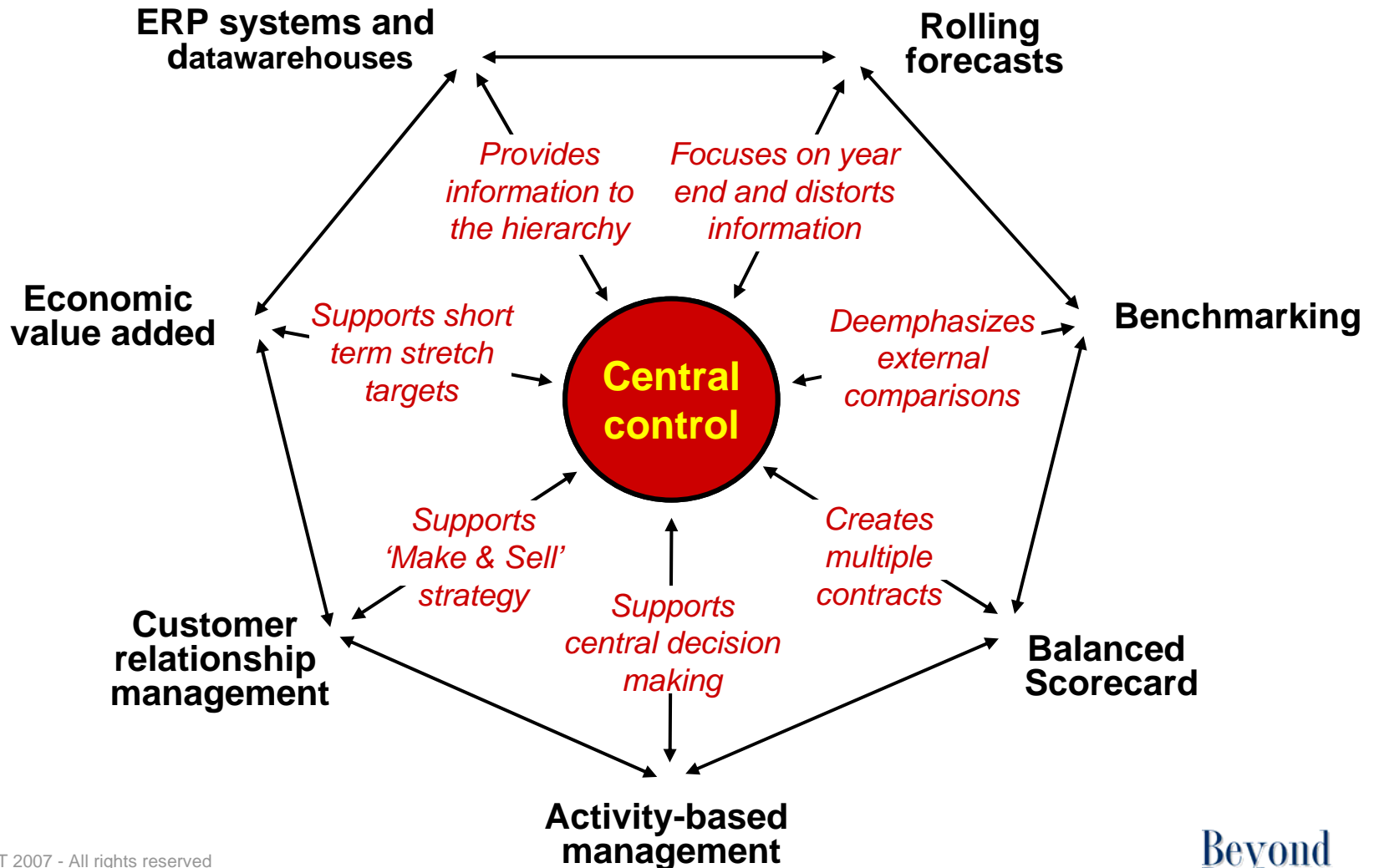
Self-regulation and control

Measure and improve end-to-end processes



Information is in the work

Why tools often don't work well



Devolved & Adaptive Models



What they have in common

‘Devolved’ leadership

- > Create network of **customer** focused teams accountable for results (‘pull’, not ‘push’)
- > Give operating units **autonomy** within a high responsibility culture
- > Establish **framework** of goals, values and boundaries, and open information

‘Adaptive’ processes

- > Aim continuously to improve **relative** to peers, with shared rewards for success
- > Respond to market changes, using **continuous** planning and a few KPIs
- > Enable teams to acquire resources **as needed**, with dynamic coordination

What they *don't* have

'Centralized' leadership

- > Functional hierarchy with centralized decision making ('make & sell')
- > Adherence to fixed plans and performance contracts (dysfunctional behaviour)
- > Governance based on rules and budgets with restricted information

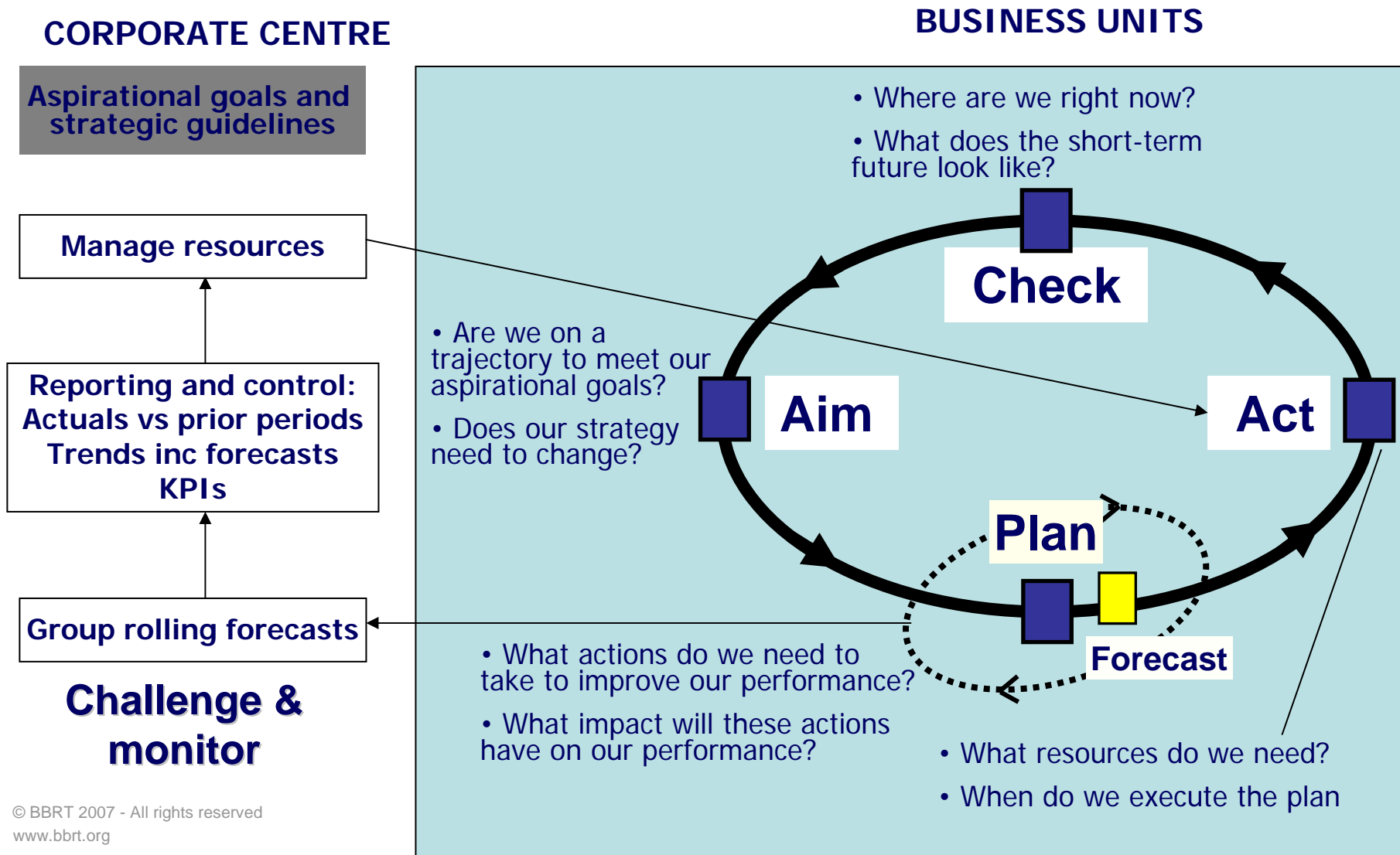
'Fixed' processes

- > Targets fixed in advance, and incentives linked to them
- > Annual fixed plans and 'budget versus actual' controls
- > Inflexible allocations of resources, and centrally coordinated plans

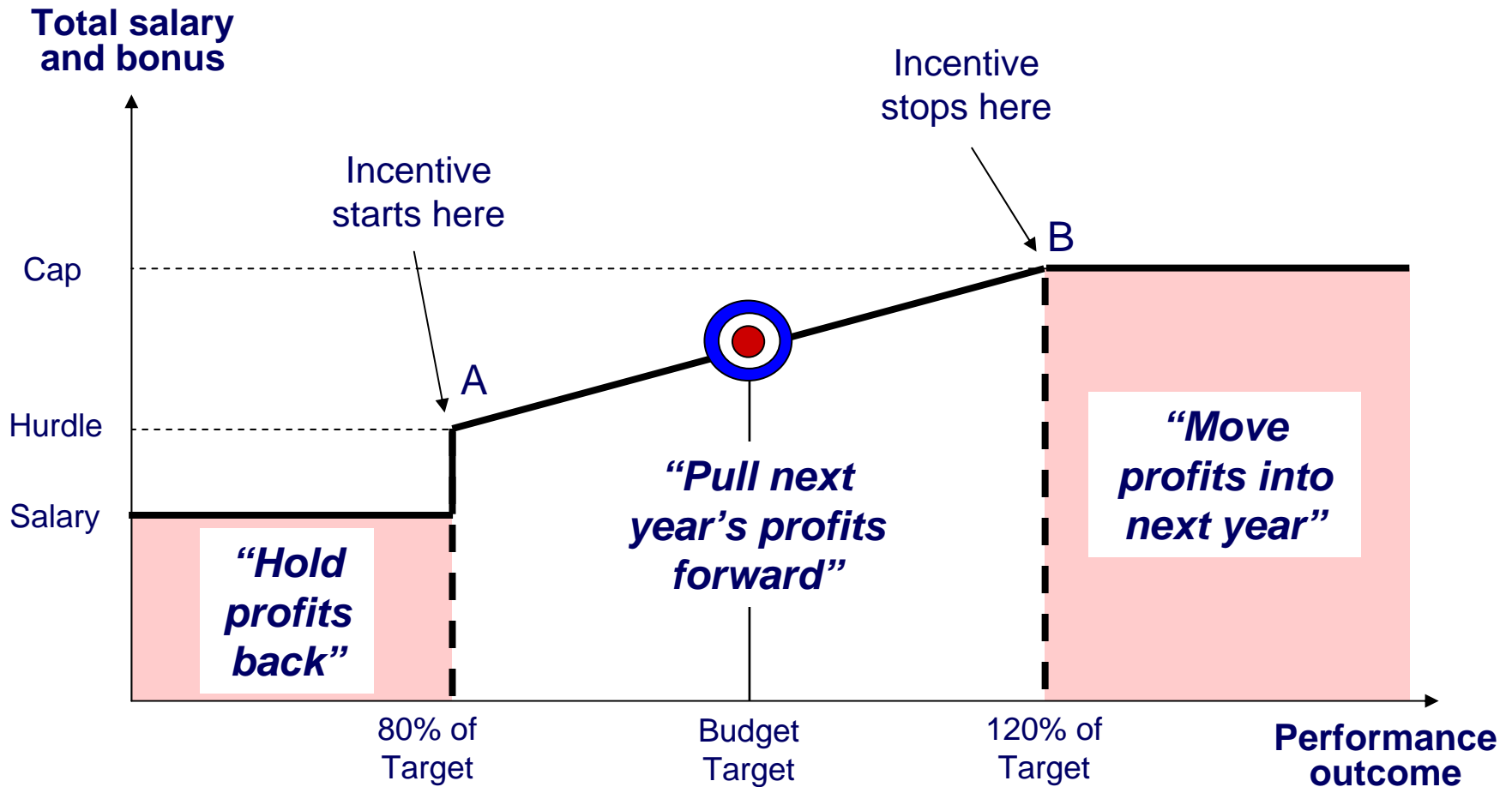
The new “control” system

1. Know what success looks like
2. Know where you are today
3. Know where you are heading in the near-term
4. Know how you are doing against peers, best practices and prior periods
5. Know if resources are following the best business opportunities

Continuous planning cycles



Avoid the fixed performance contract



Adapted from HBR article "Corporate Budgeting is Broken – Let's Fix It" by Prof. Michael Jensen, Emeritus, Harvard Business School.

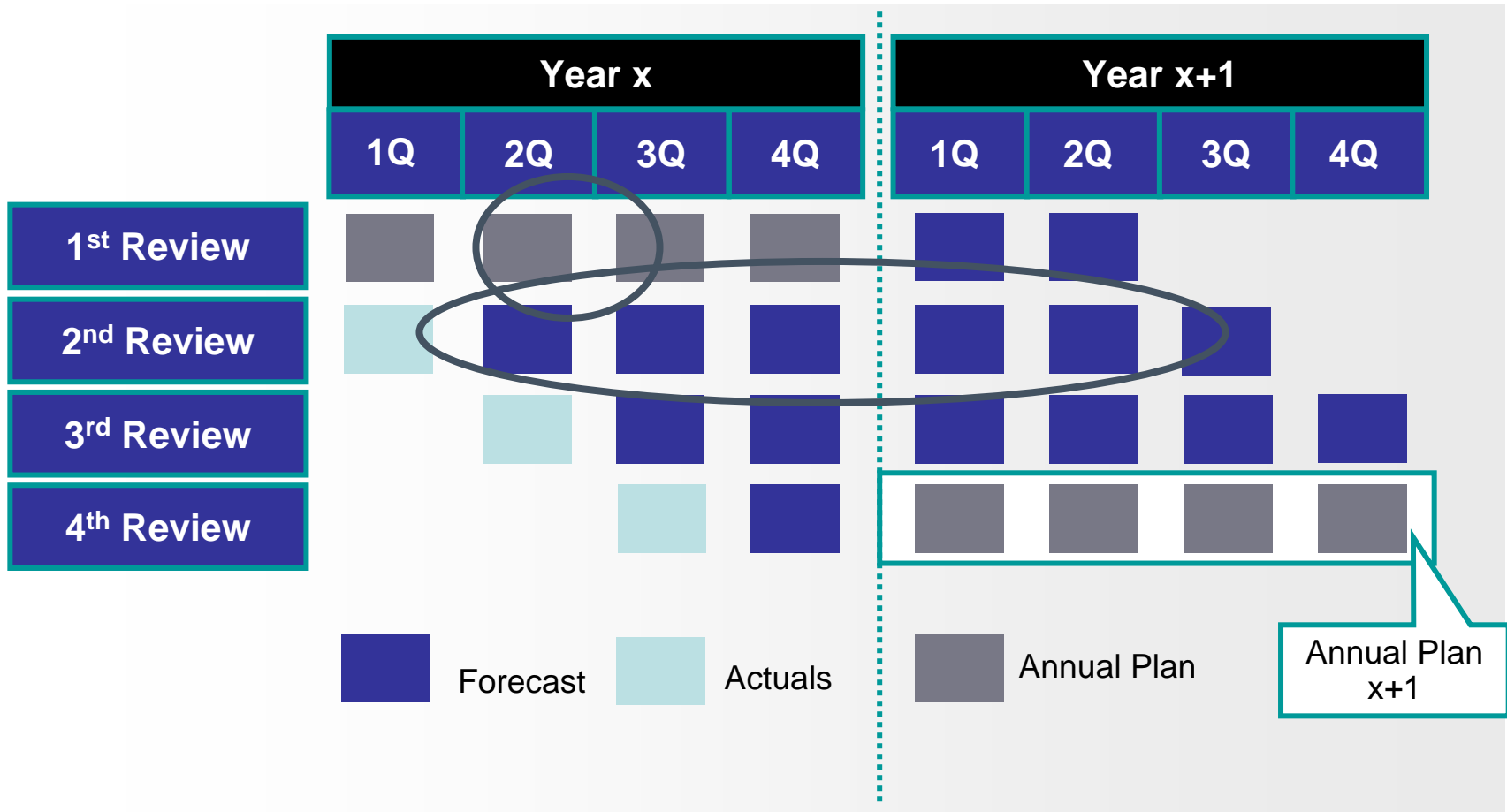
Profit sharing – Handelsbanken Oktogon

- > Based on overall corporate objective – maximum profit
- > Everybody gets the same amount
- > Deferred payout (at retirement)
- > Full share (since inception) = €750 000
- > The Oktogon owns 10% of the Bank – all staff are shareholders

Imagine a Board report like this ...

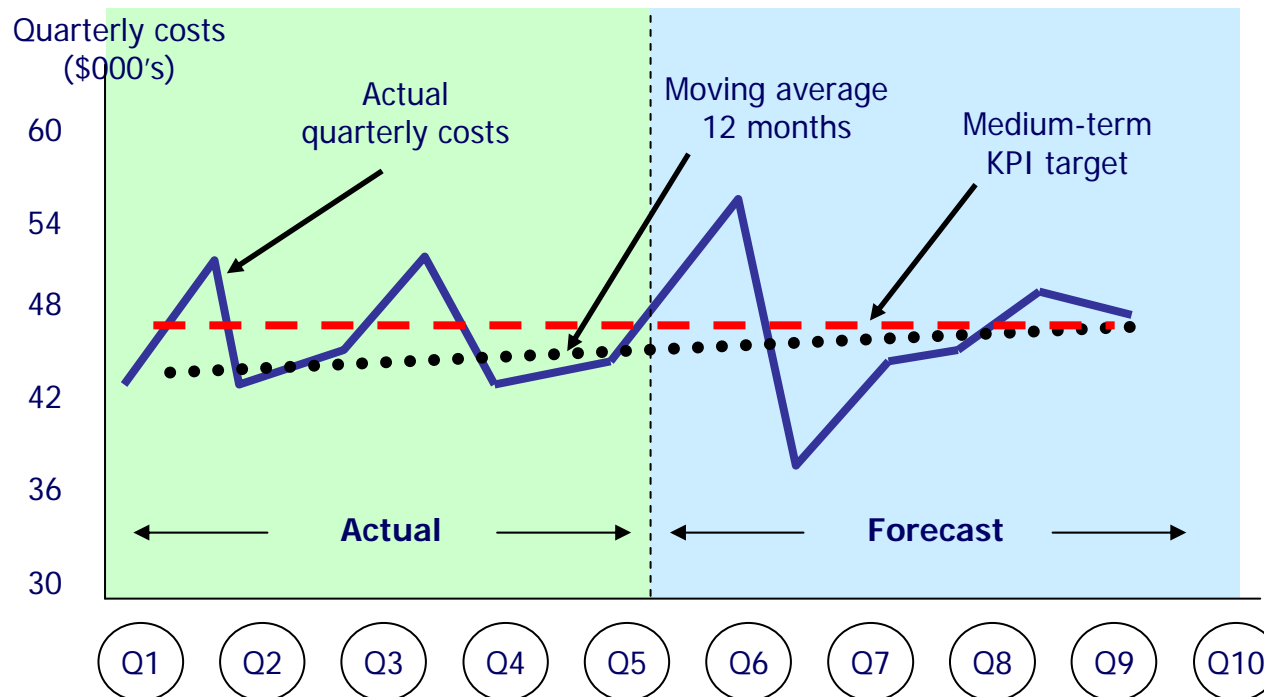
	History							Forecast					GOAL	
	Q0	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11		Q12
KEY FINANCIALS														
Orders	290	300	312	324	290	302	314	326	339	353	367	382	397	500
Sales	280	290	300	312	324	290	302	314	326	339	353	367	382	500
Gross Profits	84	81	90	87	97	84	90	91	98	102	106	110	114	175
Gross margin	0.30	0.28	0.30	0.28	0.30	0.29	0.30	0.29	0.30	0.30	0.30	0.30	0.30	0.33
SG&A costs	50	55	57	56	58	52	51	56	59	58	60	59	61	75
Net Profit	34	26	33	31	39	32	39	35	39	44	46	51	53	100
Cash flow	44	37	44	42	51	42	49	46	51	56	58	63	66	115
KEY COST GOALS (% sales)														
SG&A Costs (% sales)	0.18	0.19	0.19	0.18	0.18	0.18	0.17	0.18	0.18	0.17	0.17	0.16	0.16	0.15
Packaging costs (% sales)	0.06	0.06	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.04	0.04	0.04	0.03
Transportation costs (% sales)	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.03	0.03
IT costs (K per employee)	3.6	3.6	3.6	3.3	3.3	3.3	3.3	3.3	3.0	3.0	3.0	3.0	3.6	2.4
KEY OPERATIONAL GOALS														
First time through rate	86%	86%	84%	85%	84%	85%	87%	87%	88%	88%	90%	90%	92%	96%
On-time delivery	87%	87%	88%	85%	88%	89%	90%	88%	89%	90%	91%	92%	94%	98%
Customer retention	66%	67%	70%	68%	72%	74%	75%	75%	77%	80%	82%	84%	84%	80%
Inventory (number of days)	65.0	66.0	66.0	64.0	62.0	62.0	60.0	60.0	55.0	50.0	45.0	40.0	35.0	30.0
Accounts receivable days	92.0	90.0	90.0	88.0	82.0	82.0	84.0	84.0	82.0	80.0	78.0	76.0	75.0	60.0

Rolling forecasts at Tomkins

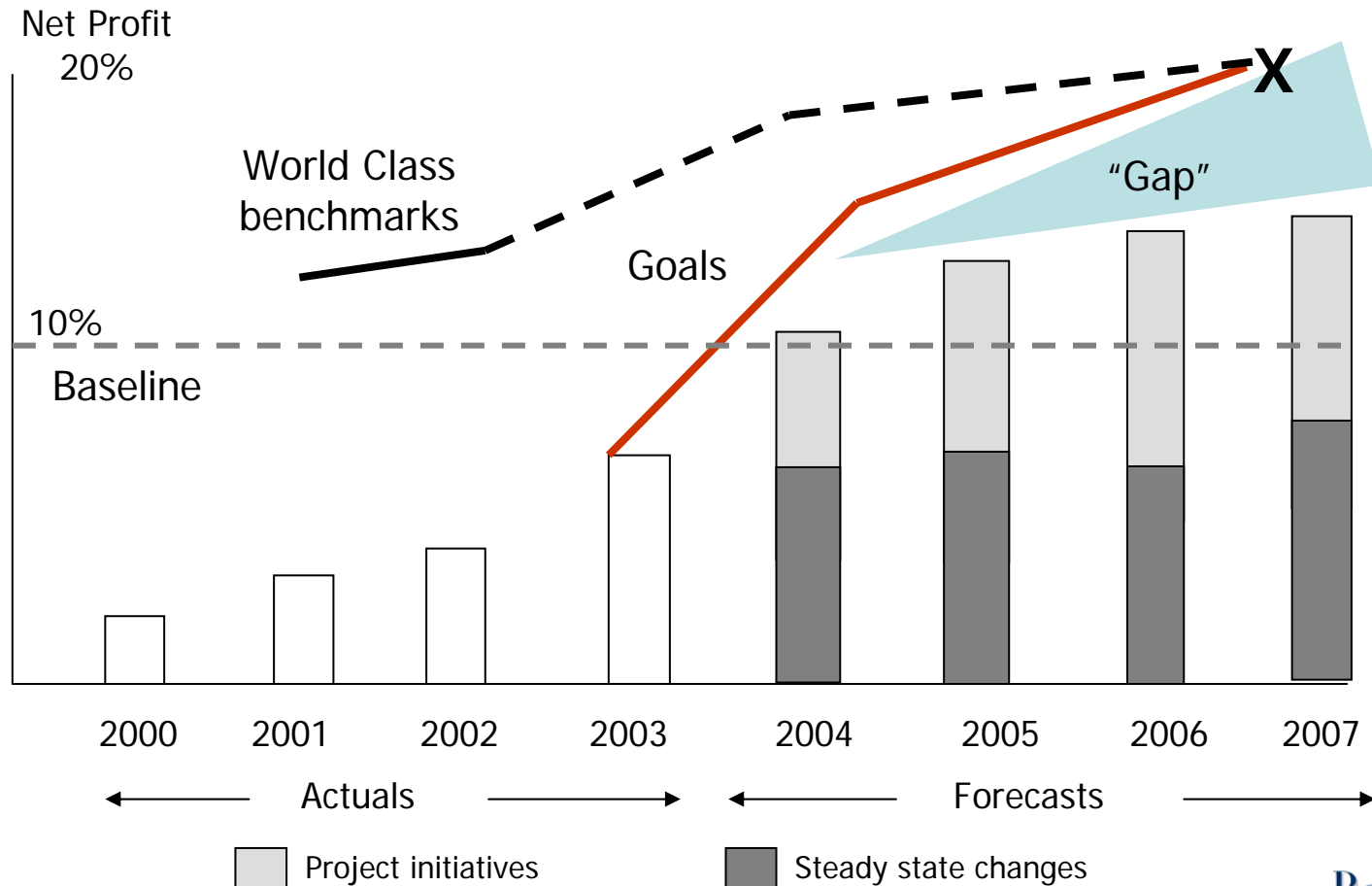


Rolling framework

Internal accounting presentation					
Cost centre	Current period	Same period last year	Current year-to-date	12 month moving average	% change - Moving average over last year



Constantly managing performance gaps



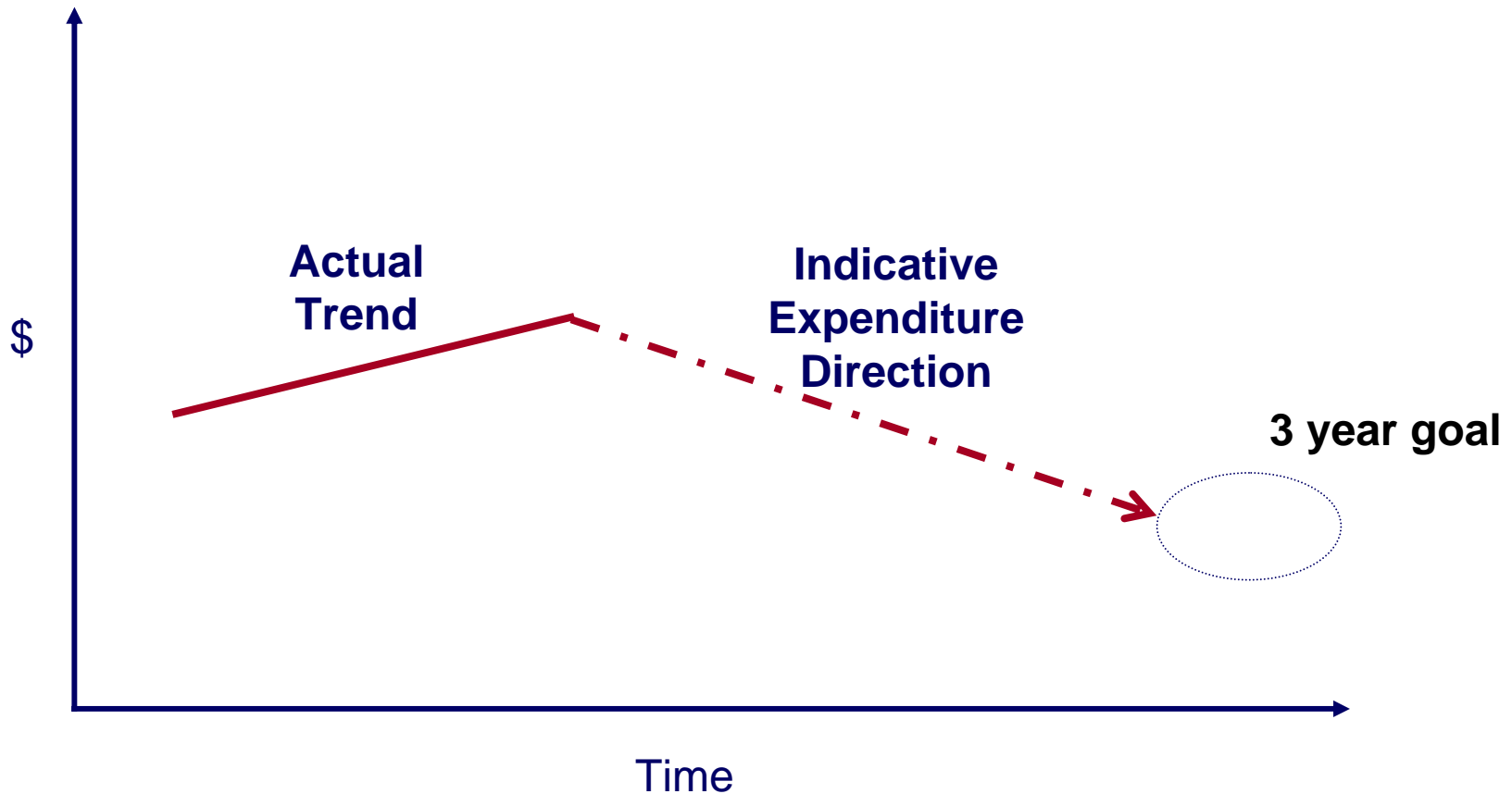
What Tomkins did

- > **Abandoned negotiated fixed targets.** Now have a performance framework of 10:10:10 (10% sales growth; 10% profits growth and 10% ROCE).
- > **Rewarded teams are rewarded on growth over prior years.** Huge impact on behaviour. Managers now focus on improvement rather than numbers
- > **Implemented rolling forecasts.** Monthly 'flash' forecasts done in middle of month project to end of month and two months ahead. QRFs also look 18 months ahead.
 - > RF's now the *primary management tool*
- > **Changed reporting system.** Now actual versus prior year plus trend analysis (inc forecasts)

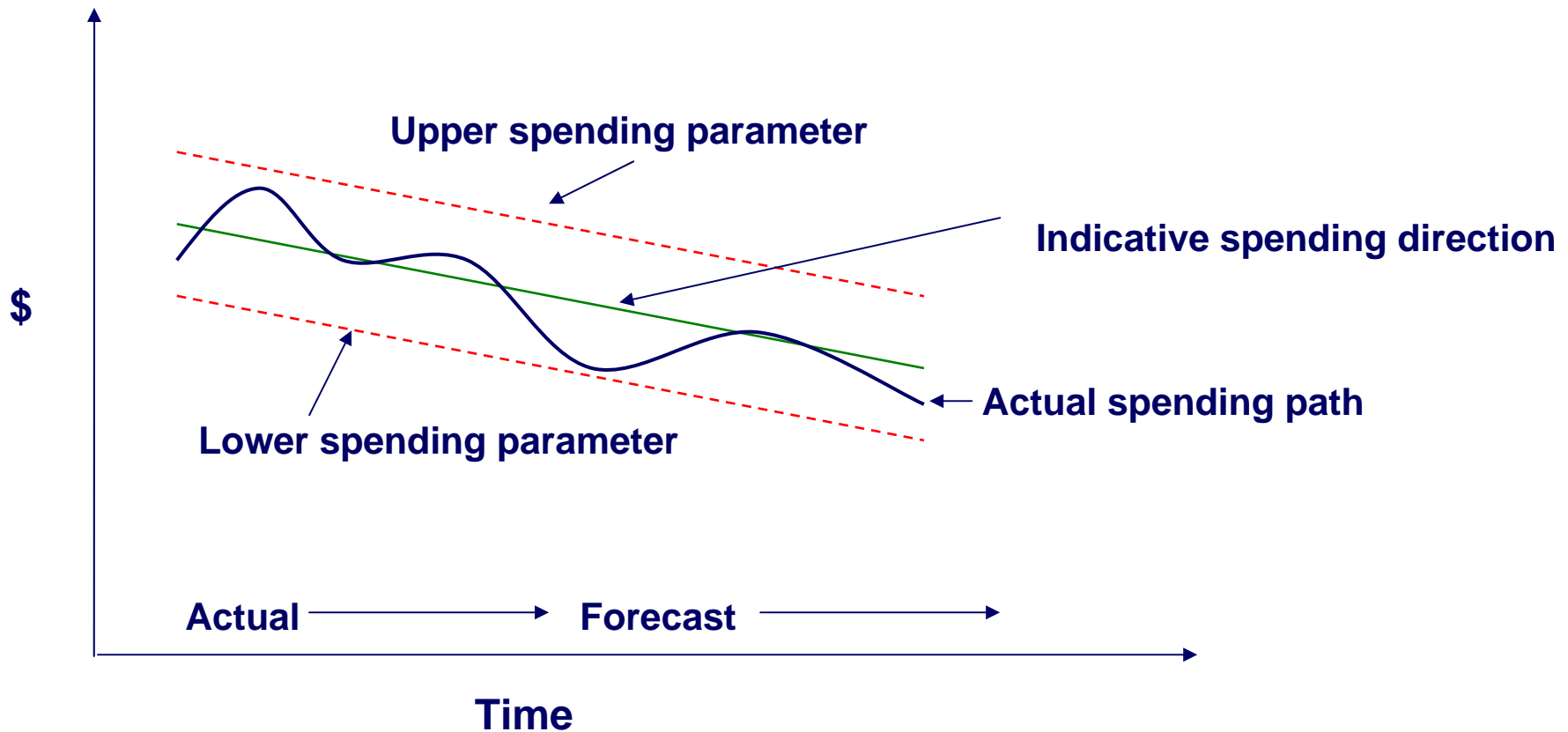
How Handlesbanken manages costs

- > The branch is responsible for all costs
- > Each branch makes its own business plan
 - > The bank is managed “bottom-up”
- > Monthly Profit & Loss and efficiency ratio (cost/income)
- > Benchmarking instead of budgets
 - > League tables compare branches

Setting directional spending guidelines



Controlling directional spending



Making it work

Theory X 'Closed' information
Micro-management

- Theory Y 'Open', transparent information
- Freedom and capability to act

Centralized functions
Hierarchical relationships

- Network of accountable teams
- Focus on customers

Fixed targets
Fixed incentives

- Peer pressure to stretch
- Team rewards for value created

Fixed annual plans
Variance controls

- Rolling forecasts / planning
- Trends, MATs and KPIs

Allocated resources
Central coordination

- Resources on demand
- Dynamic coordination

Guiding principles of flexible planning

- > Review business unit STRATEGIC DIRECTION (which businesses are we in?), POSITION (which customers do we serve?), and CORE PROCESSES (do they support our strategy?) at least once every 2-3 years
- > See strategy in terms of BUSINESS PURPOSE AND DIRECTION with improvement decisions being DEVOLVED TO SELF-MANAGED TEAMS
- > ABANDON FIXED PERFORMANCE CONTRACTS and devolve planning, forecasting and decision-making to front-line teams
- > INTEGRATE PLANNING within the continuous team-based improvement process
- > USE TOOLS AND MODELS only to support TEAM-BASED SELF-IMPROVEMENT

Rolling forecast guiding principles

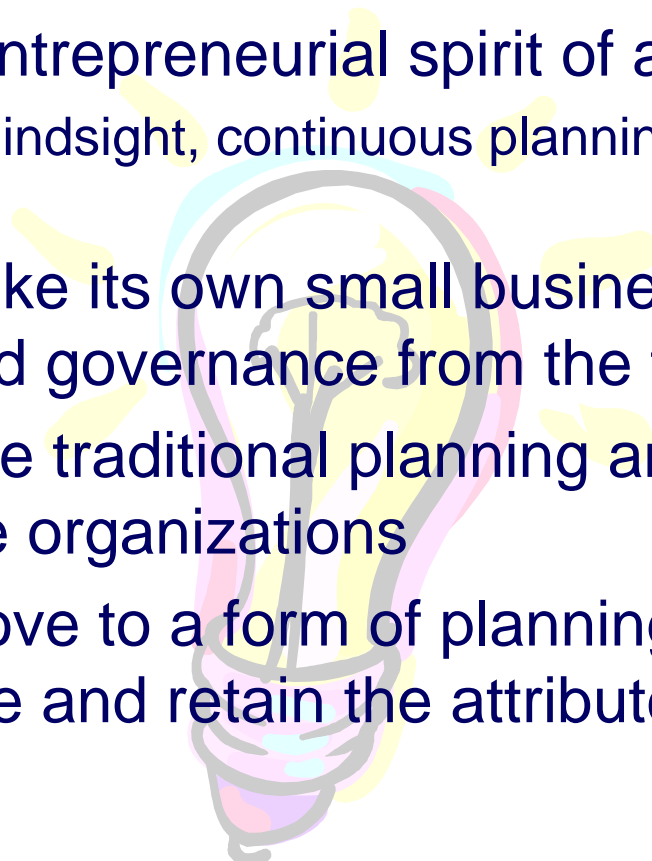
1. DO NOT CONNECT FORECASTS WITH PERFORMANCE TARGETS OR EVALUATION
2. Use a 'LIGHT TOUCH' process with minimal resources and FEW DETAILS to compile forecasts ("off-line" if possible)
3. Focus on only a few KEY DRIVERS to prepare forecasts rather than bottom-up numbers
4. Use DEDICATED MODELS not spreadsheets
5. Use a COMMON language, methodology, models etc
6. Base forecast intervals on DECISION CYCLES
7. Base the FORECAST UNIT on a STATISTICALLY VALID LEVEL OF ACTIVITY OR DEMAND
8. INTEGRATE FORECASTING in the BU decision-making process
9. Provide RANGES OF OUTCOMES (do "best guess" forecasts first, then add probability distributions to show uncertainty - Use STATISTICAL METHODS where possible)
10. AGGREGATE ROLLING FORECASTS UP THE ORGANIZATION to provide a MOVING PICTURE of current and future performance
11. Encourage the immediate SHARING OF "BAD NEWS"
12. Do "POST-MORTEMs" (forecasts against actual outcomes) to learn from past experiences

Devolving strategy

1. Make accountability for strategy clear down the line
2. Teams share common language for discussing strategies and common process for development
3. Skilled strategic thinkers with continuous dialogue
4. Encourage free, rigorous and fact-based debate –
“No Blame” culture
5. Pursue long-term goals, not just quarterly results

Conclusions

- > Re-create the entrepreneurial spirit of a small company,
 - > Rewards with hindsight, continuous planning, devolving power and authority
- > Each unit acts like its own small business, but the coordination and governance from the top
- > DON'T adopt the traditional planning and budgeting process of large organizations
- > As you grow move to a form of planning that enables you to be responsive and retain the attributes of a small company



Thank you

Dr Peter Bunce
BBRT

745 Ampress Park

Lymington

Hants SO41 8LW, UK

Tel: +44 1590 679803

Email: peterbunce@bbrt.org

Diagnostic web site: www.bbtrdiagnostics.org

Main web site: www.bbtr.org