Developing an Effective Risk Based Performance Management Process

In the previous paper in this series "Manage Risk – Make Money", I described the central role risk management now plays not just in minimizing losses but as a strategy for sustaining profitable growth. So how do you adapt your performance management processes to address and profit from effective risk management?

Make All Your Management Processes "Risk Aware"

Humans by their nature value predictability and certainty – we love to be right! Unfortunately this attitude all too often permeates our management processes. We create very detailed long term strategies often accompanied by ten year financial projections that describe in exhaustive detail a single view of the future that has almost no chance of coming to fruition. Beyond this we develop annual budgets that provide to two decimal point accuracy a precisely wrong estimate of spending for every line item in our chart of accounts. Most executives understand the futility of the exercise particularly in today's increasingly uncertain and volatile markets but struggle with changing processes and behaviors that have been decades in the making.

So just how do you go about embracing uncertainty in your performance management processes? Let's look at each of the major elements of a typical process starting with strategic planning and moving on through tactical and financial planning (budgeting), and forecasting and describe some of the techniques that best practice companies are using.

Strategic Planning

Larry Bossidy former CEO of Honeywell described strategy as "…'c9 a roadmap lightly filled in, so that it gives you plenty of room to maneuver." (Execution, Larry Bossidy and Ram Charan, Crown Business, 2002). Unfortunately, too many strategies are so detailed and rigid that managers are reluctant to deviate from the prescribed course even when it is self-evidently flawed. One of the key attributes of an effective strategy is the ability to respond to events, both positive and negative, within the framework of the analysis and decision making that went into its development.

Creating strategies that offer both flexibility and direction may seem contradictory goals; in fact the reverse is true. By employing the right tools and decision making frameworks during the strategy development process organizations can meet both objectives. By embracing tools such as scenario planning and option evaluation organization's can model their decision making under different sets of circumstances thereby enabling fast, confident decision making when an opportunity presents itself. I got to see this up close while serving as Head of Corporate Planning at Bank of America. Chairman and CEO Ken Lewis explained that his expectation of the core businesses of the bank was to provide the company with the means (capital and cash) to take advantage of attractive opportunities as and when they present themselves. This core strategy of agility was clearly demonstrated when the deal to acquire Fleet Boston was announced in October 2003 less than two weeks after Fleet's

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chairman first approached the bank. This scenario was repeated less than two years later when Bank of America announced its acquisition of MBNA just over a week after MBNA approached it after talks with the banks' cross town rival Wachovia broke down. Both decisions were predicated upon a set of strategies and plans that anticipated that such opportunities would present themselves and that speed of action would be crucial to success. Developing a clearly defined strategy is perfectly consistent with agile and fast decision making – in fact in today's volatile and uncertain world – its essential.

Tactical and Financial Planning

Tactical and financial planning (budgeting) should be the most loved and valued management process in your organization. There I have said it and you are probably laughing out loud – but it's true. The planning and budgeting process is the one time managers have the opportunity to step back from the day to day and look out into the future, yet for all too many the process is an exhausting exercise in creating meaningless detail which is then subjected to endless review and political infighting that only serves to reduce ownership and accountability to zero. There is a better way!

Exhibit One

An Increasingly Volatile World

What's Planned	What's Budgeted
Customer acquisition	Rent
Customer retention	Travel
Talent develoment	Depreciation
Innovation	Office supplies

Source: Sonax Group

Developing tactical plans and budgets to execute against a chosen strategy is at the heart of most company's annual planning processes. Decisions regarding investment priorities and resource allocations define how the company will operate and set the bar for measuring performance. Incorporating risk and uncertainty is not complicated. The first step is to organize plans and budgets around things that matter. Too many budgets carve the business up into meaningless department and expense categories. Exhibit 1 illustrates the gap between what's typically budgeted and what's important.

Once the plan and budget are correctly organized it then becomes straightforward to align the different projects and initiatives with each element. This alignment allows for much tighter integration between projects, initiatives, investments and the core tactical and financial plans providing managers with immediate visibility to the positive (or negative) impacts of the tactics being deployed and the results being delivered – often an area of weakness.

Every project or investment must, in addition to defining the critical factors for its success, also define its critical "failure factors". That is -- those circumstances under which the project or investment is no longer likely to be successful. These failure factors can then be translated into metrics that serve as an early warning mechanism thereby allowing the organization to restructure or cancel a project before good resources and money are thrown after bad.

Starting with a sound tactical plan allows for a well constructed budget to provide a clear financial representation of the organization's tactical plan which enables:

- **clear assignment of responsibility for execution**
- **managers to take full ownership of both operational and financial plans**
- **confident decision making about resource allocation**
- **a set of measures to be defined that not only track performance but also provides early warning of potential problems or opportunities**
- **a direct linkage between operational actions and their financial consequences**

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So why do most budgets fail on all counts? The primary reason is that most budgets represent a single, static and purely accounting view of the business which severely compromises their usefulness as performance management tools. Tactical plans and budgets need to:

- **Include contingency plans that allow the organization to meet its targets under a range of future scenarios.**
- **Define the expected relationship between key business drivers (both internal and external) and expected financial results**
- **Evaluate projects and initiatives based on both strategic fit and economic value.**
- **Identify the risk factors in all aspects of the plan.**
- **Establish clear milestones and interim decision points**
- **Be fully integrated with the forecast process.**
- **Balance the level of detail with the organization's predictive ability.**

A sound tactical and financial plan shades in most of Larry Bossidy's "roadmap" but still offers a range of alternative routes that allow an organization to reach its destination (target) under different circumstances.

Forecasting

In today's fast moving and uncertain markets, forecasting is becoming the single most important management process. The ability to quickly and accurately detect changes in key external and internal variables and adjust tactics accordingly can mean the difference between leading and lagging the market. Unfortunately many companies are hamstrung by forecast processes that are overly mechanical, internally focused and financial in nature; frequently sales, production and finance forecasts paint very different pictures leading to confused execution. Again the rules for effective forecasting are simple:

- **Forecasts must integrate both the external and internal drivers of the business and the financial results**
- **Absolute forecast accuracy is less important than insight about how current decisions and future events will interact to shape performance**
- **The number is less important than the assumptions and variables that underpin it – those are the things that should be tracked to provide advance warning of opportunities or threats**
- **Detail does not equal accuracy with respect to forecasts – match your desire for detail with your predictive capability**

Southwest Airlines is an excellent example of an organization that has aligned its performance management practices to the volatile business environment in which it operates. The airline industry is subject to significant variability in both revenues and costs; these trends have been magnified in recent years as the cumulative effects of 9/11, Hurricanes Katrina and Rita, and $70-per-barrel oil make the continuous understanding of current and likely future trends essential. Southwest develops an annual budget which serves as a basis for estimating the resources required to deliver income and cost estimates within manageable ranges; however, these budgets are updated every quarter for the quarter ahead to reflect the best current information. The quarterly budgets are then further supported by 12-month rolling forecasts which allows Southwest to adapt its resource allocations to volatility in the market.

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Combining long term direction with near term visibility and agility are the hallmarks of an effective forecast process.

The Role of Technology

Creating an agile and risk aware performance management process is difficult to accomplish if you are relying on numerous disconnected spreadsheets that are periodically refreshed by random downloads from numerous different transaction systems. Performance Management systems are essential vehicles for identifying, monitoring, and managing risks as part of an integrated performance management process. Princess Cruise Lines provides a useful illustration of the value of technology in supporting not just more efficient but more risk aware management practices.

Princess Cruises is a unit of Carnival Cruise Lines operating 15 cruise ships that serve over 1.2 million customers a year. The cruise business is complex, combining all aspects of a full service hotel including spas, bars, retail stores and casinos with a shipping business operating on a global basis. In late-2001 Princess, like the rest of industry was struggling to adapt to a world changed by 9/11, a major risk if ever there was one, which served to make all previous plans, forecasts and budgets obsolete. Princess' finance team spent hundreds of hours reworking numerous spreadsheets as the company sought to establish a new baseline from which to manage. They got the job done but it was painful and lacked the value added insights that they should be providing; so in 2002 the company embarked upon an ambitious program to completely reinvent their planning, budgeting, forecasting and analytical processes and take advantage of the new planning and performance management tools that were increasingly available. As Greg Bozigian, the Director of Financial Planning at Princess at the time commented, "we needed to be able to rapidly adapt our plans and forecasts to changes in our markets or operating model and spreadsheets simply could not cope."

Princess implemented a new set of performance management applications to support the development of the plan for fiscal 2004. Bozigian commented that, "the benefits exceeded our expectations, not only could we support a bigger business with no increase in staffing but we transformed the role of the finance team – we were able to consistently deliver high value analysis in very short cycle times allowing our operators to make much better decisions, much faster." The benefits have been significant:

- **Speed** – budgets, forecasts and plans can be developed and consolidated across the company in minutes where it formally took days; management requests for focused analysis can be answered in hours. For example, a manager in the retail division can see the projected revenue and cost of sales for every voyage by every ship based upon the forecast of passenger numbers; previously such information would have required days of data collection and consolidation.
- **Accountability** – business managers can see daily analyses of performance, flowing into monthly forecasts and annual plans. Managers use the tool to dynamically make changes as a result of the decisions made.
- **Operational relevance** – Princess has successfully integrated the key operational drivers of its business into the financial representation of that business. For example the cruise line equivalent of a retailers same store sales metric is $ per available lower berth day or $ per ALBD. Princess is able to rapidly model changes in projected revenues and costs based upon changing patterns of berth utilization and pricing thereby allowing operational managers in all departments to better optimize their own operations.

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- **Flexibility** – right in the middle of developing the fiscal 2005 plan, Princess Cruises administrative and operational departments took over responsibility for Cunard the venerable British operator of the QE 2 and the new Queen Mary 2. The planning team was able to seamlessly replicate their base planning model and tools to allow for a plan to be developed for Cunard without adding any additional resources.
- **Responsiveness** – a major cost driver for Princess is fuel and with the rapid increase in oil prices, the finance team has been able to run multiple scenarios looking at the relationships between operating days of each ship, fuel consumed and the cost per metric tonne so that the company could optimize its profitability in the face of a material change in one of its key cost elements.

Using technology to focus performance management processes on the right things is a critical element of being able to effectively support a business operating in a volatile and uncertain world – and today that means all businesses.

Conclusion

The days of detailed, static plans and budgets that offer only an accounting view of the business are numbered. Volatility, uncertainty and risk dictate that companies develop a set of performance management practices that allow managers to identify, understand and model risk as a continuous part of their management process. The combination of best practices and state of the art technology provides managers with the means to turn risk management into a key component of their ability to sustain profitable growth.

About The Author

David Axson is an author and consultant. A former co-founder of The Hackett Group and Head of Corporate Planning at Bank of America he is a highly regarded public speaker. His most recent book is Best Practices in Planning and Performance Management (Wiley 2007). For more information visit DavidAxson.com.

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