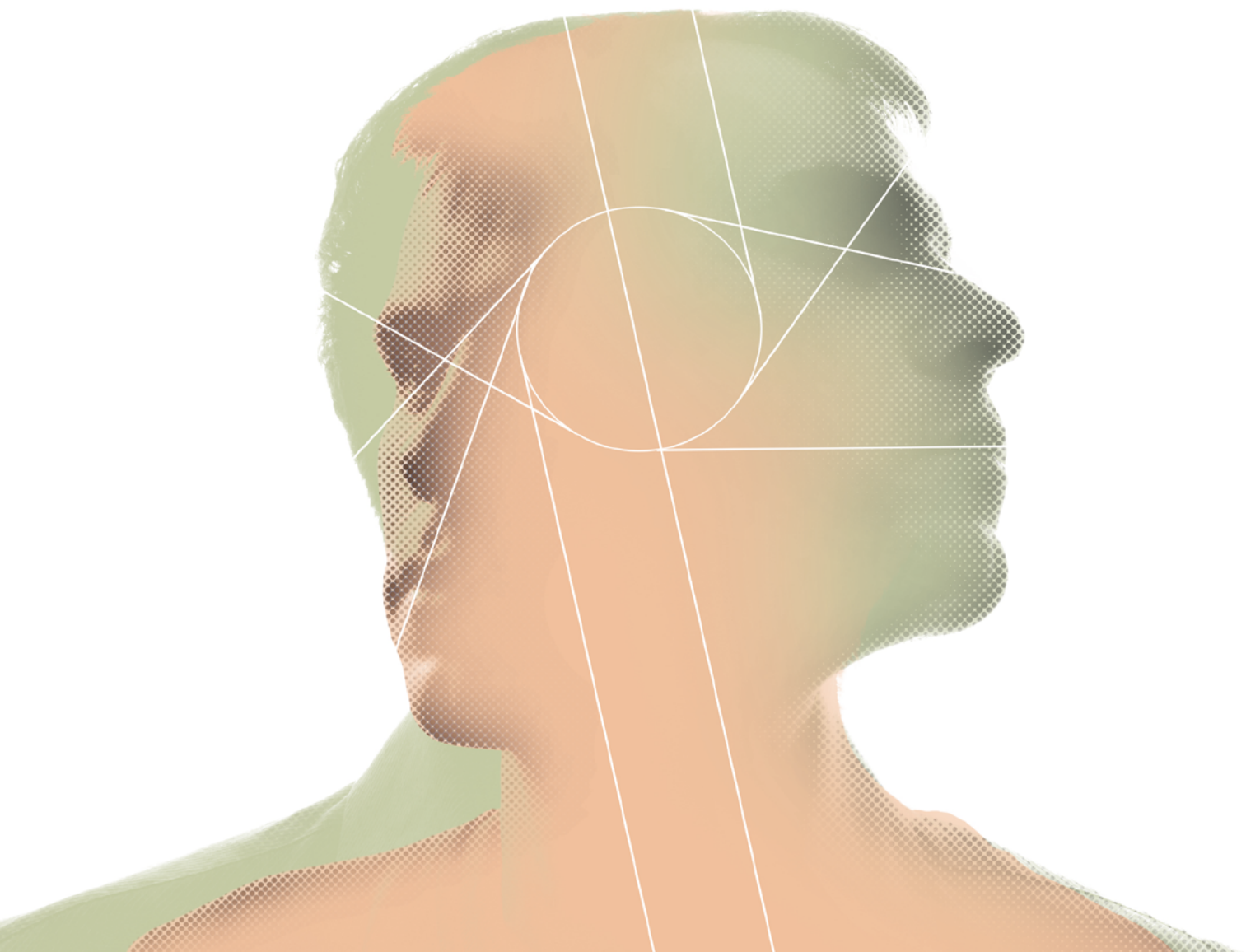


***Business Performance Management  
Report 2 - working with tensions***



# ***ICAEW Finance Direction initiative***

*Business Performance Management Report 2 – working with tensions* forms part of the Business and Management Faculty's Finance Direction thought leadership programme. It provides practical guidance on dealing with the issues raised in the earlier report *Business Performance Management – approaches and tensions* (2015). All Finance Direction reports, which focus on making finance functions more effective, can be accessed at [icaew.com/financedirection](https://www.icaew.com/financedirection).

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## *Executive summary*

Business performance management (BPM) is central to the success of all organisations. It encompasses how organisations define, assess and improve the delivery of their business goals. However, all organisations have tensions inherent in their BPM approach. This report identifies the most common tensions, and offers suggestions on how to deal with them.

Organisations exist within an operating environment subject to change and uncertainty. This has always been the case. On the one hand it can be argued that many things stay the same or change slowly (eg, human nature) and that disruption now is no greater than in some periods in the past. On the other hand, technological advances, new business models and political upheavals, among other factors, contribute to a sense that the pace of change and the level of uncertainty is ever increasing. Whatever the reality, a changing and uncertain world conflicts with our desire for predictability. Indeed, assumptions of predictability form the foundation of many of the BPM tools and processes used by the finance professional, from strategy development to budgeting.

The most important response to the effect of change and uncertainty on BPM is to remain agile. BPM processes should not be set up once and assumed to be permanent. Instead, performance management should be seen as an opportunity for continuous improvement. We should set out our business strategy and then – as things inevitably change – constantly recalibrate our operations and plans.

Tensions associated with the misalignment of people's interests are some of the most prevalent. These range from a mismatch between staff interests and those of the organisation, to the challenge of dealing with multiple stakeholder demands. And while tensions of all types interact with each other, it is the misalignment of people's interests that has the most frequent and complex interaction with

the other tensions. In response, BPM can be used to set clear goals that align people with organisational goals, albeit imperfectly and often only temporarily. Therefore it is important to change staff, reward systems and structures if they no longer support your strategy.

The lens through which you view an organisation affects how you measure success. And if there is a bias towards either operational or financial measures then you will get an incomplete picture of business performance that may compromise decision making. Financial measures do provide a unified measure of value that, when used wisely, can act as a clear signal for action. However, it is critical that the link between financial outcomes and their operational drivers are fully understood to inform the right responses.

The information that you use to feed your BPM processes needs to be tailored for the purpose. Too often businesses use information that has been structured for statutory reporting. Informed decision-making needs information that highlights performance against key success factors, matches operating cycles, is produced on a near-time basis, includes both operational and financial measures and is free of non-decision related account balances.

Tensions are inherent within all organisations and their BPM processes. They cannot be 'solved'. However, it is still important to be able to recognise them, particularly in a constantly changing operating environment, and adapt your approach accordingly.

BPM itself is an ongoing cycle, and an opportunity for continuous improvement. There is no perfect one-size-fits-all approach. It is about constantly aiming for a 'good enough solution' through a process of trial and error. Such a demanding task calls for finance professionals with strong business knowledge who are able to exercise professional judgement.

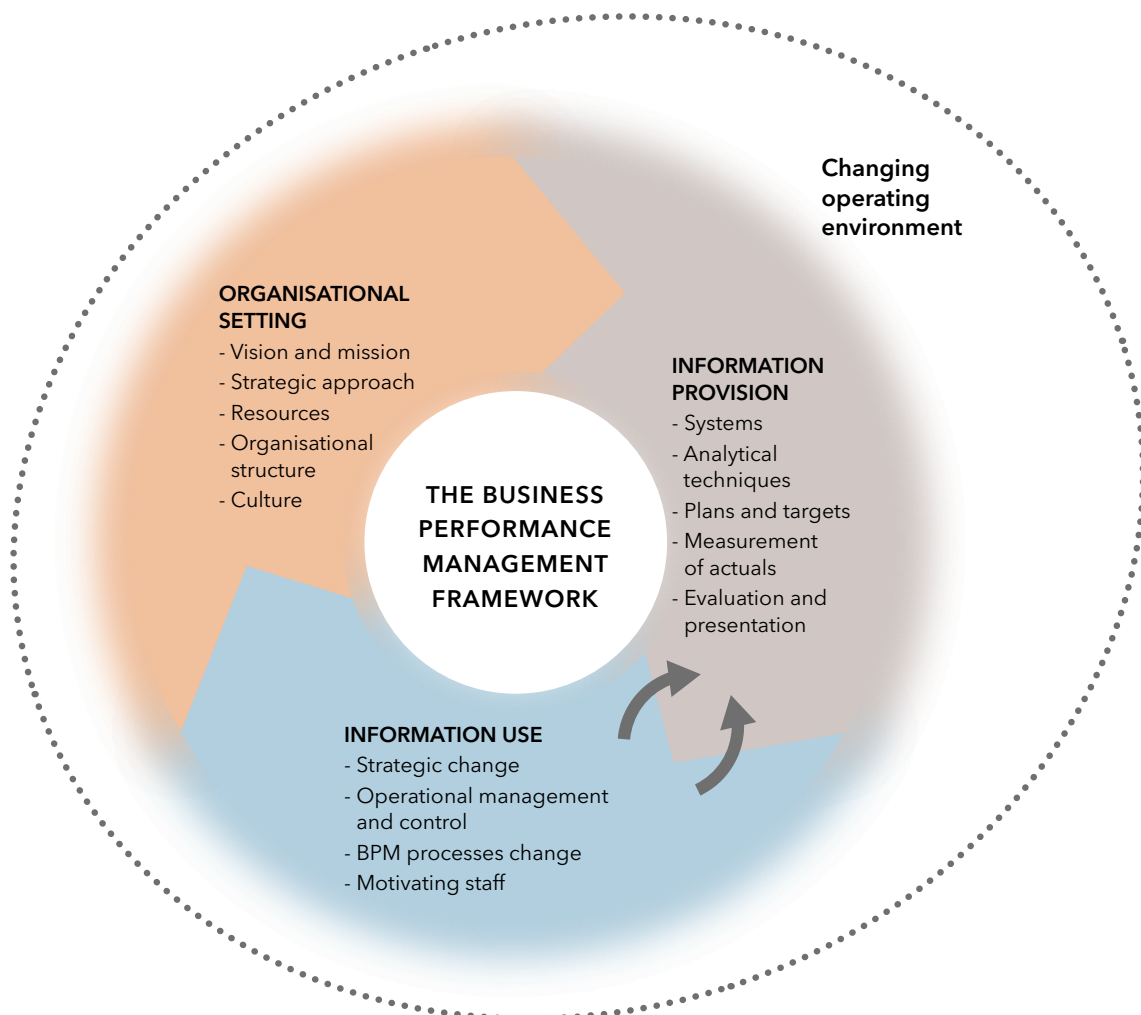
## *Business Performance Management: a review*

Business performance management (BPM) refers to the approach an organisation takes to define, assess and improve the delivery of its business goals. It is central to the success of all organisations.

In 2015 we published *Business Performance Management - approaches and tensions*. In that report, we set-out a framework to help finance professionals clarify their thinking on BPM, map their approaches against ours and explain BPM to others in their organisations. We also introduced the concept of tensions – or conflicting forces within organisations, which disrupt business performance.

The BPM framework (Figure 1) summarises the widely recognised elements of business performance management. It is made up of three components: organisational setting, information production and information use. In its simplest form, it mirrors the Deming cycle: Plan – Do – Check – Act. For detailed guidance on the model see our previous report [www.icaew.com/bpmtensions](http://www.icaew.com/bpmtensions)

While a framework is useful for clarifying your thinking around BPM, we believe that being able to recognise and deal with performance tensions as they occur is the real key to achieving success. And so, in this second report, *Business Performance Management Report 2- working with tensions*, we have lifted the tensions out of the framework to give them the attention they warrant and examine them in more detail (Figure 2).



## *Inherent tensions*

Performance tensions are inherent throughout BPM. Examples include conflicting stakeholder interests, exposure to uncertainty or an imbalance between the use of operational and financial measures. If not addressed, these tensions can reduce the effectiveness and efficiency of an organisation, potentially frustrating the achievement of business goals. However, it is through working with these tensions that finance professionals show their mettle.

Tensions can occur at any point in an organisation's approach to BPM, and they will have a knock-on effect throughout its performance management processes. Multiple tensions interact, and the misaligned interests of people and stakeholders in particular are commonly seen acting in combination with other factors. Multiple sources of information (a systems and information collection tension) being exploited by individuals to manipulate results and achieve personal targets (a staff, structure and culture tension) is one example.

The prevalence and impact of misaligned interests is the reason we have placed this tension at the centre of our model (Figure 2).

In the rest of this report, we set out common tensions and explain where you may encounter them. We also provide some anonymised case studies, to illustrate the tensions. While the case studies have been allocated to the most appropriate sections of the report, you will find that - reflecting real life, where tensions interact and occur in combination - each case features more than one tension in action.

Most importantly, we offer some suggested approaches to deal with the tensions you encounter. However, as all organisations are unique, and tensions occur and interact in many ways, there is no one-size-fits-all approach to BPM. Additionally, there will be choices to be made between equally valid approaches to all aspects of BPM. Therefore your own professional judgement and business knowledge are crucial to decision making and achieving business goals.

FIGURE 2: BPM TENSIONS



# Identifying and working with tensions

## 1. UNCERTAIN WORLD VERSUS DESIRE FOR CERTAINTY

Dealing with the external environment.

TENSIONS	SUGGESTED RESPONSES
<b>Uncertain world versus human desire for predictability</b>	<ul style="list-style-type: none"> <li>• Treat BPM as an opportunity for continuous improvement.</li> <li>• Treat strategy as stable, but be ready to respond.</li> <li>• Do not stand still while things around you change.</li> </ul>

### Uncertain world versus desire for certainty - where you may see the tensions

#### Difficulties in defining and achieving success

All organisations operate within a changing and, to a greater or lesser extent, unpredictable environment. Where there is rapid change it is even more difficult to agree your vision, mission and strategic approach, as what looks like success today, might have changed tomorrow. This has knock-on effects throughout the organisation. Today's resources might not meet tomorrow's needs; a legacy structure might not be able to deliver future plans; and, the prevalent culture might not be able to adapt fast enough to keep up with changing aspirations. This can be complicated by our general desire for predictability, which may make us blind to the impact of change.

In addition, new technologies are having a significant impact on businesses. The opportunities offered by big data and artificial intelligence, for example, are matched by their disruptive influence in the hands of competitors. New business models are constantly evolving. These include revenue that's driven by clicks not cash; products (both physical and virtual) that can be increasingly, and more cheaply, customised to individual consumer demands; and, winner-takes-all platform strategies (exemplified by Google, Uber and Facebook).

### Uncertain world versus desire for certainty - suggested responses

#### Treat BPM as an opportunity for continuous improvement

All plans and targets are based on assumptions about the future, which may or may not prove right. Because of this, implementation of your strategy is unavoidably a matter of trial and error. Business performance management should be seen as an opportunity for continuous improvement. You make plans, set targets and measure success. You should then use the feedback to take corrective operational actions, or to adjust your strategy. In a rapidly changing environment, you also need to test the assumptions that underpin your strategy regularly.

Essentially, managing the performance of your business is a case of ongoing calibration. BPM provides the opportunity to learn from mistakes and start the cycle again. For example, in a turnaround situation you may set up a plan that covers three months. If, after two months, results are signalling that the recovery was unrealistic, and that sales are not coming in as quickly as expected, then you may need to scrap that plan altogether and start from scratch. This should not be seen as a failure; it is BPM in action. Variances are being used to make informed and rapid business decisions. In a more stable organisation the plan may take the form of an 18-month, or longer, rolling forecast, which only needs reviewing on a quarterly basis.

### **Accept failure as a learning experience**

Particularly in uncertain times, failure to meet a plan should be viewed as part of the necessary trial and error process, rather than an occasion to apportion blame. For example, in Case Study 1, changes imposed by customers threatened profitability. Once operational changes had been made, the plans and forecasts were then updated on a rolling basis. The BPM approach was continuously tweaked.

### **Treat strategy as stable, but be ready to respond**

While accepting the trial and error nature of BPM, for practical purposes treat your strategy as stable. However, be ready to respond to signals for change. Despite incomplete knowledge you need to decide what action to take. Have a working hypothesis of what is achievable and test it. This is important because, day-to-day, staff need a clear focus for action, and treating the strategy as stable will help you communicate what they should be doing and how.

When presenting actual performance and discussing plans with stakeholders, highlight the level of uncertainty. This will enable informed decision making. An opportunity for a very high return but less than 50% chance of success may be accepted by an investor with a high risk portfolio approach, but not by stakeholders with a low risk appetite.

Building up cash and other resources is another possible approach to uncertainty, and this can provide you with room for error and the flexibility to respond to unexpected changes. On the negative side, it can lead to management complacency and lower return on asset ratios.

### **Don't stand still while things around you change**

Be alert to step changes in the external environment and adapt your resources and structures appropriately. John Maynard Keynes wisely said, 'the difficulty lies not so much in developing new ideas as in escaping from the old ones'. If the existing structures are no longer appropriate, then change them. In the longer-term, more money can be wasted by finding work-arounds and paying for ad-hoc fixes. Consider splitting the organisation into profit centres which better reflect the new operational reality and so provide more clarity for decision making.

However, always remember that, while organisation structures are important and getting them right is a key foundation for enabling performance, other aspects such as the quality of the management team and key staff, resource allocation and culture can be just as important. Make sure these are addressed too (see Section 8 'Misaligned interests' on p25).

**CASE 1: £50M LOGISTICS COMPANY****Background**

A private equity (PE) backed logistics company, with a turnover of £50m, had quadrupled its size over seven years through a mixture of organic growth and targeted small acquisitions. Its business was the provision of warehouse, transport and logistics services to industrial customers, governed by contracts of up to five years. Performance was underpinned by a mix of financial and non-financial BPM processes reporting on each of the contracts.

The financial BPM reported the weekly and quarterly performance of each contract on a near-real-time basis. Each week the weekly actuals and the forecast for the quarter were assessed on a rolling basis against a quarterly plan for each contract. This plan was initially determined from the contract terms, but updated to take account of any known or planned changes. The cumulative result of all the updated contract plans, less corporate overheads gave a rolling company profitability plan.

**Trigger for change**

An exit was agreed to a competitor on favourable terms, based on the latest profitability forecast. During the detailed negotiation of the deal, it became apparent from the rolling BPM updates that customer changes to the terms of several major contracts could have a severe impact on profitability. However, management also identified that these changes provided opportunities to increase profits if managed effectively. The management contacted the purchaser and highlighted the potential difficulties and opportunities. A six-month delay in the exit was agreed.

**Using BPM for continual improvement**

During this pause, customer requirements and contracts were reassessed. Rolling BPM processes were used to provide a continual evaluation of their potential financial impact. This led to contract renegotiations and service delivery changes which resulted in increased profits.

**Outcome**

The exit negotiations were restarted and a successful sale was finalised.



## 2. OPERATIONAL VERSUS FINANCIAL PERSPECTIVES OF SUCCESS

The lenses through which you view the organisation will affect how you view and measure success.

TENSIONS	SUGGESTED RESPONSES
<b>Operational versus financial perspectives of success</b>	<ul style="list-style-type: none"> <li>• Use both perspectives.</li> <li>• Use the strength of financial measures as a signal for action and as a measure of value.</li> <li>• Use costed operational actions as a response.</li> <li>• Ensure the links between measures are understood.</li> </ul>

### Operational versus financial perspectives - where you may see the tensions

#### Both operational and financial metrics have weaknesses when used in isolation

BPM information has both operational and financial dimensions, and each has its advantages and disadvantages when measuring success. Stakeholders can favour one type of metric over another, which can cause them to view, measure and drive performance from a limited perspective. An ill-considered selection of measures can provide a weak foundation for decision making.

Operational measures are concrete but disparate. They are the direct result of actions (such as, planes departed on time, or sales calls made) and so are easily understood by people in the organisation. This makes them useful as triggers for change. However, as a group they are disparate (customer satisfaction scores, delivery times in hours, returns as a percentage) and they do not necessarily directly represent value.

Financial measures are unified, but fragile. They provide a unified measure of value (money) and so are widely accepted and easily communicated to a variety of audiences. However, they are partly based on historic measures (that may no longer be relevant) and adjusted for future assumptions (that may change). Some examples are fair value accounting, depreciation rates and other provisions.

#### The link between measures may be lost

The impact of one type of measure on the other can be ignored, or simply not understood. For example, there may be a focus on the cost of training without taking into account the impact on culture change (privileging financial cost measures); or, a focus on speed of goods despatch over the costs associated with using part-filled trucks (privileging operational measures).


### Operational versus financial perspectives - suggested responses

#### Use both perspectives

Ensure you use both operational and financial metrics to obtain a more comprehensive view of performance, since they are interlinked and interdependent. Ultimately, financial outcomes are the result of operational actions, and so, those financial outcomes can only be altered by understanding what drives them and then making appropriate changes to operational activities.

Financial metrics can provide a simple signal of whether an organisation, or an individual business unit, is delivering to plan. For example, you might identify a fall in margins or increased staff costs. To respond, the connected operational metrics need to be identified (such as increased headcount). From there, operational actions can be proposed (perhaps restructuring staff levels and roles), then costed, and their financial and operational impact assessed. Informed actions can then be taken.

You will also need to have operational indicators in their own right eg, those testing the quality of products and services. But once again, before any corrective actions are taken, the costs of those actions need to be assessed.



***Ultimately, financial outcomes are the result of operational actions, and so, those financial outcomes can only be altered by understanding what drives them and then making appropriate changes to operational activities.***

Often you will find yourself moving back and forth between financial and operational measures. One may have underperformed. But is some change in another measure the reason? For example, sales volumes may be down, but if mid-way through the period you increased prices, then this may be an inevitable and acceptable consequence.

Also, revisit your choice of key operational measures on a regular basis. Some of them, such as output volumes or headcount, are straightforward choices depending on your business model. However, others may have been selected because they were relevant to the business at a point in time. It is important to review operational measures to make sure they are relevant to your current circumstances and are useful in driving behaviours consistent with the current objectives. For example, store footfall might have been relevant when 95% of products were sold through retail stores, but is it still relevant when more than half of sales are online?

#### **Ensure the links between measures are understood**

You (and others in the organisation) need to understand the links between your operational and financial measures. If not, then it will be difficult to react effectively when variances occur. Case Study 2 illustrates such an example where the link between operational realities and financial planning was lost.

## CASE 2: MOTOR DEALER

### **Background**

The owner-manager of a long-established motor dealer brought in an experienced accountant to improve financial controls and performance reporting. As part of this, the accountant produced a financial plan built using a standard commercial forecasting accounts package, with prudent assumptions concerning sales, margins, overheads and staff costs. It was not, however, built up from a costed assessment of operational drivers, nor did it reflect the operational structure of the company. This plan indicated that future trading performance and borrowing requirements were going to breach the existing bank covenant.

The plan was then submitted to the bank as part of the standard annual review. This triggered the bank to place the company into special measures, and commission a formal financial review from a leading corporate recovery firm. This process caused internal friction, disrupted trading and resulted in the departure of the accountant. The financial review recommended a range of actions including the appointment of a turnaround specialist.

### **Using BPM to maintain the link to operational actions**

The turnaround specialist set up a different forecasting process. Revised P&L and cash flow forecasts were built, based on the costed ongoing trend in the operational performance of the company's three trading divisions: new cars, parts and service. These were adjusted to take account of profit improvement actions that could realistically be implemented in response to changing patterns of demand. This reassessment indicated that the earlier forecast had been overly negative. It had been undertaken as an accounting exercise, without direct linkage to the underlying operational realities. The new approach revealed that the financial outlook was not pressing, and the company was actually in no danger of trading insolvently.

### **Outcome**

The company continued to trade successfully, although in a weakened position, because of the disruption. The process had been costly and stressful for the company, and had risked causing a terminal loss of confidence.

### 3. SHORT VERSUS LONG-TERM PERSPECTIVES

Establishing your measures of success over different time periods.

TENSIONS	SUGGESTED RESPONSES
<p><b>Short-term success versus building for the future</b></p>	<ul style="list-style-type: none"> <li>• Have a plan for the short term that flows through into your long-term vision.</li> <li>• Do not use long term goals as an excuse to ignore current problems.</li> <li>• Challenge your long-term assumptions.</li> <li>• Debt is the only long-term certainty. Use it to set a floor in your cash flow plans.</li> </ul>

**Short versus long-term perspectives - where you may see the tensions**

**Adopting a short-term approach can limit future potential**

Focusing on short term profitability and quick-wins without developing a strategic plan for the future can limit long term value generation. For example, failure to invest in staff development can limit future performance. Similarly, failure to build up a strong financial base can reduce your ability to withstand shocks and respond to opportunities.

**Focusing disproportionately on the long-term can risk business survival**

Clearly there is no long-term without the short term. Plus, there is the risk that the assumptions you make about the future will be wrong. Watch out for 'false truths' (eg, will property prices really always rise?).

**Short versus long term perspectives - suggested responses**

**Have a plan for the short term that flows through into your long-term vision**

Without a short-term there is no long-term. However, without a long-term there is no point in the short-term. Plans and rolling forecasts can provide a link between actual performance in the present and future aspirations. These need to be continually updated and not seen as one-off budgets that can be set and then ignored in future years (see Section 6, 'Conflicting use of plans and forecasts', on p21, for more on rolling forecasts).

**Don't use long term goals as an excuse to ignore current problems**

When facing a tricky, current problem it can be tempting to focus on the less-urgent long term, with disastrous consequences. One example of this occurred in an SME building company that was facing an uncertain future. Its management proposed expanding out of the problem. They decided to open more stores to drive sales and to help cover existing overheads. However, this meant that staff focused on the expansion rather than trying to work out why the business model was not working in the first place. Due to a poor understanding of the financial drivers, the expansion actually increased overheads and worsened the financial situation.

### Challenge your long-term assumptions

It is risky to treat your assumptions as certainties when they form the foundation of long-term plans. Ensure you review them regularly, particularly in response to changes.

Scenario planning is important. How much headroom does the organisation have in different market circumstances? Use stress tests to assess the tolerance of your business plan to changes in key drivers, and set flags for operational and financial measures that track those drivers. For example, if a 20% fall in sales volumes would cause covenants to be breached, you might set flags for increasing levels of action at 5%, 10% and 15%.

### Debt is the only long-term certainty - use it to set a floor in your cash flow plans

As debt is a fixed liability use it to set the floor of your cash flow forecasts. Your downside cash flow projections must have a good chance of meeting any repayment requirements. And, although different stakeholders will have different risk appetites, failing to meet debts can be terminal. Building up a cash contingency can provide a buffer against uncertainty.

***Plans and rolling forecasts can provide a link between actual performance in the present and future aspirations.***



#### 4. SYSTEMS AND INFORMATION TRADE-OFFS

Information systems are used to collect, record, aggregate, produce and analyse BPM information. This information includes both performance results and future projections. How systems are structured will affect the data available to inform decision making.

TENSIONS	SUGGESTED RESPONSES
<p><b>Systems and information trade-offs around:</b></p> <ul style="list-style-type: none"> <li>• <b>Cost versus value</b></li> <li>• <b>Fragmented systems</b></li> <li>• <b>Informal versus formal systems</b></li> <li>• <b>Multiple sources</b></li> <li>• <b>Speed versus reliability</b></li> </ul>	<ul style="list-style-type: none"> <li>• Make decision support the purpose of your BPM information.</li> <li>• Match solutions to the size, complexity etc, of your organisation.</li> <li>• Let information needs drive IT investment.</li> <li>• Use a mix of operational and accounting systems.</li> </ul>

##### Systems and information trade-offs - where you may see the tensions

###### Cost versus value

It can be difficult to prove the cost/benefit case for investment in BPM systems and to sell it to the rest of the business. Often, even if you have identified shortcomings with your current approach, limited resources may be allocated to other areas.

###### Fragmented systems

With limited resources and the pace of change, IT systems can often be added to in an ad-hoc manner, leading to a mix of systems that are poorly integrated. Management may need to choose between costly (and disruptive) upgrades and accepting the problems caused by fragmented systems, such as the need for manual work-arounds.

Investment in new technologies, such as cloud based software, robotic process automation (RPA) and artificial intelligence (AI) have the potential to deliver major benefits. However, there is long record of major investment programmes in new technologies that have failed to meet expectations.

###### Informal versus formal systems

Many organisations use a combination of formal and informal systems. In SMEs and younger businesses, the proportion of informal processes can be relatively high and can often depend on an individual's know-how. Informal systems are more flexible and less costly, but knowledge may be lost as staff (particularly the founders) move on. Often, informal controls can become inadequate as an organisation grows.

###### Multiple and conflicting sources of information

Conflicting sources of information are a common source of tension at management meetings, and can confuse and delay decision making. Causes might include fragmented systems, poor version control or individuals' preferences for information from operational versus accounting systems.

###### Speed versus reliability

For information to be useful in decision making, it needs to be produced and communicated before events have moved on. However, it also needs to be reliable. The controls that ensure accuracy often slow down its production.

### **Systems and information trade-offs - suggested responses**

#### **Make decision support the purpose of your BPM information**

Management information needs to be available that focuses on the critical aspects of an organisation's performance. To obtain this, you need to identify your organisation's key success factors and use these to set its key performance measures. Access to the data that is needed to calculate and forecast these measures should be prioritised when building and updating systems. Being clear about this information, and its benefits to the organisation, can help support the business case for investment.

Perfect systems may not be a realistic aim. Furthermore, fragmentation is not a significant problem unless it impairs the production of information needed for decision making or results in inordinate costs. While there is no requirement for absolute precision, data must be consistent and materially valid.

#### **Match solutions to your organisation's circumstances**

Consider an organisation's size, complexity, sector and stakeholder aspirations when planning its systems. For example, in smaller organisations, basic accounting and off-the-peg operational management systems can be adequate, particularly when senior management are closely involved.

#### **Let information needs drive IT investment**

Only invest in new systems when a clear information need has been identified. It will be time consuming and costly, so the benefits need to be clear.

Use the information needs you have identified to explain your requirements to whoever is building or supplying the systems. It can be easy to get distracted by the (potentially superfluous) information that the systems they are offering can produce. Using a spreadsheet to model the reports you would like to extract can be a good way of testing how useful they will be.

#### **Use a mix of operational and accounting systems**

A combination of both systems is crucial to produce useful and robust performance information (as in Case Study 3). Operational data will often be sourced from systems tailored to a specific industry, such as production planning, transport management, or staff activity systems. Since this information comes directly from operational activities, and often in real time, it can inform any corrective action rapidly. Plus, the levers for change should be clear.

However, as we will discuss in Section 5, Competing analytical approaches on p17, operational systems lack the controls of accounting systems. For example, sales may be recorded in a CRM system which do not end up being invoiced or reflect incorrect pricing. When the validity of operational information is suspect it can lead to fruitless discussions about what numbers are correct and disrupt effective decision making. It is here that information sourced from accounting systems becomes invaluable through its potential to provide validation of operational data.

**CASE 3: DIRECT SELLING KITCHEN COMPANY****Background**

A quoted PLC conglomerate identified a start-up growth opportunity in the direct selling kitchen sector. A complex multi-site operation and a hierarchical management structure was set up to exploit the opportunity, supported by a multimillion-pound investment.

**Trigger**

The BPM approach and management structure were set up to meet the requirements of the PLC, not the needs of a fast growing start up. The BPM reports, designed to meet the PLC management and reporting requirements, indicated a failing level of performance. Further, despite several interventions from central corporate executives, the PLC could identify no clear way forward, and exited to the operational management at a nominal value.

**Using integrated operational and accounting systems to drive effective BPM processes**

Freed from the restriction of the PLC, a flat management structure was developed driven by a focus on three key success factors:

- cost and strength of lead generation;
- lead conversion rates and margin achieved by sales agent; and
- completing installations on time and in full within a week.

Performance targets for each of these factors were set, which would deliver good levels of profitability. Achievement was monitored through weekly reporting. Shortfalls triggered swift responses, either financial (eg, adjusting margins) or operational actions (eg, in lead generation, sales effectiveness or service quality).

These weekly BPM metrics were supported by rolling monthly reporting of actual performance, plus rolling 12-month profitability and cash forecasts. These were formatted to reflect the weekly metrics. This crucially allowed the following:

- a) Retrospective validation of the reported weekly costs and margins to ensure their integrity. When material variances were identified, actions were taken to improve the systems that collected operational information.
- b) Use of sales lead measures and order metrics as leading indicators to inform the rolling 12-month profitability and cash forecasts. The time between initial lead generations, via order conversion and on to installation was three to six months. Consequently, the company-wide profit and cash impact of any upcoming changes in performance could be assessed ahead of time, allowing responsive action.

**Outcome**

From a background of being loss making, the company rapidly moved into good profitability and cash generation, which was used to fund rapid growth. This was followed by a successful exit.



## 5. COMPETING ANALYTICAL APPROACHES

Your analytical approach encompasses how you aggregate and analyse the data that your systems have gathered. It can include both automatic and manual processes. Often the analysis is built into an organisation's systems (for example, cost allocation) and so can become seen as the normal way of doing things.

TENSIONS	SUGGESTED RESPONSES
<p><b>Options and tensions that make deciding on an analytical approach more complicated:</b></p> <ul style="list-style-type: none"> <li>• Multiple techniques</li> <li>• Analytical perspective</li> <li>• Time horizon</li> <li>• When to change</li> <li>• External financial reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Start by understanding your key success factors and cost/income/cash relationships.</li> <li>• Reconcile the financial results of operating cycles with monthly financial accounts.</li> <li>• Maintain a link between monthly financial accounts and operational realities.</li> <li>• Do not ignore proven techniques that fit your income/cost relationship.</li> </ul>

### Analytical approach - where you may see the tensions

#### An overwhelming choice of options

There are many ways in which performance can be analysed and a huge range of tools that have been developed to help organisations do this. Recent advances in AI and machine learning provide further options. All approaches will have strengths and weaknesses, and it can be difficult to get a clear and unbiased view of these. If the approach management adopts does not reflect how the organisation operates this can lead to decisions being made based on inappropriate information.

#### Taking the wrong analytical perspective

Mistakes can be made when deciding what unit of analysis to take. For example, should analysis be carried out at organisational, divisional or business unit level? Take too wide a perspective and crucial detail may be overlooked; take too narrow a perspective and the overall picture may be lost.

#### Using inappropriate time periods for analysis

Formal reporting periods may not be best suited to performance management. Organisations often produce management accounts on a monthly basis, but this does not match operational cycles. Operational cycles can range

from days, in the case of financial market trading, or years, in the case of new drug development. Even when an organisation's operating cycle may be measured in weeks, these do not fit neatly into calendar months.

#### Failing to recognise the need for change

As the organisation and its operating environment evolve, the existing BPM approach may become less appropriate. A desire for consistency can delay change. Also, frequently the poor fit is not noticed, as the technique itself has come to shape the way we see the organisation.

#### Using information that is tailored to external financial reporting

Accounting systems are often set up with the need to produce the annual financial accounts in mind. But the aggregations that have been set up for external reporting are unlikely to suit performance management. The analysis can combine costs in a way that obscures the impact of operational actions, and a drive for 'one version of the truth' can contribute to this problem. An example is when both fixed and variable cost are included in gross margin percentage calculations, which results in margin variances as sales volumes change. These variances are driven by notional allocation of fixed costs rather than any true operational causes.

Further, particularly in publicly listed companies and financial services, the relationship of BPM and statutory reporting can be subtle. What is in the statutory accounts (even if it is of limited use operationally) can have an impact on capital requirements, the share price and the perception of stakeholders. A tension can therefore exist between approaches that will benefit the share price and those that management judge to be best operationally.

### **Analytical approach - suggested responses**

#### **Start by understanding your key success factors and cost/income/cash relationships**

As when designing your BPM systems (Section 4), the starting point is to identify the key success factors, income/cost/cash relationships and key performance measures so that your analyses will focus on these.

#### **Reconcile the financial results of operating cycles (eg, weekly or project duration) with monthly financial accounts**

Effective BPM should include reporting of both natural operating cycles (for example, weekly or the duration of a project) and financial management accounts (which are normally monthly). Operating cycle reporting provides a direct link to operational activities. It should be produced on a near real-time basis so that it can inform any corrective action that needs to be taken.

Financial accounting generally follows payment cycles, and so operates monthly. It provides the input for monthly accounts, rolling forecast updates, and annual statutory reporting. Financial accounting brings with it the assurance of the double entry system.

While operating cycle reporting and financial accounting have different perspectives and uses, they are intrinsically compatible. This is because they are fed by the same underlying transactions. It is important to test this connection by carrying out reconciliations. To do this, operating cycle information needs to be coded and aggregated in a manner equivalent to the general ledger codes.

Reconciliations do not have to be absolutely precise, but they do need to be robust enough to ensure information integrity. Reconciliations can be performed between balances from operational and accounting sources for any chosen period once they have been adjusted for cut-off differences. Or, if reconciliations are carried out quarterly, you can take advantage of the fact that three calendar months (for financial reporting) is equivalent to 13 weeks (of operational reporting).

Ideally, these reconciliations will be done automatically by enterprise resource planning (ERP) systems that collect both financial and operational information. Even if this is not the case, software add-ons, RPA and AI promise to take over mundane tasks like reconciliations, while being able to deal with ever increasing volumes of data.

#### **Maintain a link between monthly financial accounts and operational realities**

Consider how the operational realities of the organisation can best be reflected in its analytical approach. For example, consider splitting the organisation into profit centres for performance reporting, as illustrated in Case Study 2.

Also, do not make the mistake of using reports pulled directly from your accounting system that have been structured to suit statutory reporting or standard accounting package classifications. This can lead to the inclusion of non-decision related accounting balance in management reports. It is better to use disaggregated balances aligned with business activities that will enable you to analyse cause and effect more cleanly.

**Do not ignore proven techniques that fit your income/cost relationship**

While techniques such as advanced analytics may have value, do not ignore more traditional management accounting techniques that have stood the test of time. These include activity based costing/absorption costing or throughput/marginal costing. The most suitable techniques (traditional or otherwise) will depend on the individual business context and will change. Expertise (internal or external) is required to judge which are most appropriate.

For example, in a logistics company, pricing for the warehousing business was driven by throughput/marginal costing as the aim was to ensure maximum contribution to cover fixed costs. However, for new fixed term distribution contracts an activity based costing approach was selected, in order to assess their total cost impact on all areas of the company.

***While operating cycle reporting and financial accounting have different perspectives and uses, they are intrinsically compatible.***



## 6. CONFLICTING USES OF PLANS AND FORECASTS

Plans and forecast help you set out how you will deliver your strategic approach.

TENSIONS	SUGGESTED RESPONSES
<p><b>Planning and forecasting tensions around:</b></p> <ul style="list-style-type: none"> <li>• <b>Fixed versus adaptive</b></li> <li>• <b>Level of budgetary slack</b></li> <li>• <b>Past versus future</b></li> <li>• <b>Motivational versus dysfunctional</b></li> <li>• <b>Benchmark comparability</b></li> </ul>	<ul style="list-style-type: none"> <li>• Use planning to set out your strategy in operational and financial terms, tested through scenarios and sensitivity analyses.</li> <li>• Develop targets to identify performance levels and provide motivation.</li> <li>• Use rolling forecasts to test if the plan is on track.</li> <li>• Take variances as signals for action.</li> <li>• Fit your time horizon to operational realities.</li> <li>• Use benchmarks to stimulate debate.</li> </ul>

### Conflicting uses of plans and forecasts - where you may see the tensions

#### Fixed versus adaptive planning

The trade-off between using fixed versus flexible planning is a long running debate and, although fixed budgets have been routinely criticised, their popularity remains. More detail on this can be found on the Beyond Budgeting Institute’s website, [bbri.org](http://bbri.org). Fixed budgets and targets provide a clear focus for activity, but quickly become outdated and detached from reality when circumstances change. Adaptive planning (including rolling forecasts, scenario planning, sensitivity analyses and stress tests) allow you to respond as the environment changes, but may not provide such a clear sense of direction.

#### Level of budgetary slack

On the one hand, budgetary slack can leave space for opportunism and innovation, but risks waste and poor financial control.

#### Past versus future performance

The accurate information we have relates to the past, but plans and forecasts are based on assumptions about the future. Plans and forecasts are therefore, by their nature, uncertain and will have varying degrees of accuracy, depending on context, which can potentially compromise their usefulness.

### Motivational targets versus dysfunctional behaviour

Individuals and teams may be motivated to pursue their targets even to the detriment of the wider organisation (this is discussed in more detail in Section 8, p25).

#### Benchmark comparability

Comparisons against other organisations (or internally, such as between business units) can be a useful measure of success. But accurate and truly comparable information can be hard to find.

### Conflicting uses of plans and forecasts - suggested responses

#### Use planning to set out your strategy in operational and financial terms, tested through scenarios and sensitivity analyses

Plans, often presented in the form of budgets, are central to BPM. However, it is important that they are produced in a constructive manner. A costed process analysis, one that links operational actions to financial outcomes, can provide the base for your plan, and act as a test of its feasibility. Set out the processes that will deliver your products or services and identify the cost drivers. How many people will be needed during the period and what will they be doing? What volume of materials will be required? Prior year costs (carefully disaggregated) can be adjusted for known changes and applied.

This approach should focus on the fundamentals that drive business performance. It is important not to get side-tracked by too much detail, which will slow the process and draw attention away from the key information.

There is often pressure from CEOs and funders to produce one set of plan numbers to reduce complexity and facilitate communication of the plan. However, such oversimplification can result in the illusion of certainty and fixation on what is just one potential outcome in a range of possibilities. This in turn may lead to destructive discussions and poor decision making. Consequently, financial goals are better seen as a range rather than one number. Scenarios and sensitivity analyses can be used to explore the likely range of outcomes and are particularly useful when an organisation is exposed to high levels of uncertainty. A key element of these scenarios is the effect on cash flow. Cash availability will always set the floor of what is possible.

Where, for practical reasons, a single scenario is used as the basis for the plan, it is important for senior management to remember that this is done more for ease of presentation than because it is a precise evaluation. If challenged to provide 'one number' it may be useful to describe the single scenario as the 'base case', making it clear that other scenarios are feasible. As always you will need to use your experience and judgement to tailor the process to your organisation.

### **Develop targets to identify performance levels and provide motivation**

Targets provide the means to focus staff on the activities and outcomes that are required to meet the plan. Targets will be specific to the organisation. They will generally be drawn from your organisation's key success factors (eg, lead generation, sales conversion or revenue per user) and include both financial and non-financial (operational) measures.

Often stretch targets (which exceed what is required to achieve the plan) will be set, to motivate staff to over-achieve and to build in a contingency to cover shortfalls elsewhere. One example of this is when overachieving on cost reduction compensates for lower sales and cash flow remains in line with the plan.

The targets that focus on the most critical aspects of an organisation's success are known as key performance indicators (KPIs). In his article, 'The new thinking on key performance indicators' (2006), David Parmenter says that there should be no more than ten such measures in an organisation. He describes their characteristics as including: being measured frequently, non-financial in nature, acted upon promptly, understood by all (including what corrective action would be needed) and able to be tied to a particular individual or team.

Parmenter also explores key results indicators (KRIs) which he says are 'the results of many actions' and which, unlike KPIs, can be financial. Variances in KRIs (such as falling sales or margins) can signal that a change is needed, but their operational drivers will need to be identified first.

**Use rolling forecasts to test if the plan is on track**

Rolling forecasts provide an up-to-date view of whether performance is on track to achieve the plan (as seen in Case Study 4). They are forward projections, based on actual results adjusted for the current trend, planned organisational changes and known or predicted market changes.

In such forecasts, the length of the period under review generally remains constant (eg, 18 months) and should be determined to fit the organisation's operating horizon. As the past period (eg, the last quarter) drops off, it is replaced by an equal future period, and so the forecast rolls on.

If a true rolling forecast process is difficult to implement, consider a year+1 budgeting process, ensuring that budgets and forecasts always extend out by a minimum of a year. Do not wait for the start of the budgeting process to provide visibility into the following year.

Also, although it can be tedious, reconciling and explaining changes from one forecast to the next is important to ensure management understand and agree with any revisions and new targets. It is important to understand the underlying causes of changes as these may be key to driving responses. One example of this is when the response to a fall in revenue arising from the loss of several customers should be different from the reaction to a short-term rescheduling of a major customer order that moves activity from one quarter to another. Use the 80:20 rule to ensure that only significant changes in forecasts are focused on.

**Take variances as signals for action**

Actuals and forecasts will be compared against plans and stretch targets to identify variances. These variances signal whether the plan is still feasible. The use of a rolling forecast as a comparator against the plan, in addition to actuals, is crucial because it can provide an early warning of performance issues. This allows a proactive rather than a reactive response. Going forward, this same BPM process will provide feedback on whether operational responses are working.

**Fit your time horizon to operational realities**

The appropriate planning time horizon will depend on the characteristics of the organisation, including factors such as its sector, stability and ownership structure. For a business in distress, this may be three months; for a stable business, it may be ten years. A private equity firm may have a planned exit timeframe of three years which provides the appropriate horizon.

**Use benchmarks to stimulate debate**

Consider how comparable measures are likely to be before placing too much reliance on them. But bear in mind that the true value of using benchmarks can be in the debate they stimulate, rather than in their exact comparability.

#### CASE 4: TRANSPORT AND DISTRIBUTION COMPANY

##### **Background**

A long-established and successful, privately-owned, transport and distribution company was acquired by a private equity (PE) syndicate. The transaction was funded by a management buy in/buy out, and the company was subsequently led by a charismatic new CEO.

##### **Trigger**

The acquisition was predicated on an aggressive growth plan that was converted into a fixed budget. This budget was then used as the central means of monitoring performance.

In the first year following acquisition, performance was ahead of budget. In the early months of the second year, performance was again ahead of budget overall. However, there were some areas of underperformance, particularly the new CEO's expansion initiatives. While this caused some concern to the board and the PE house, generally the performance was considered satisfactory. This was especially the case as the performance to date in combination with the forward budget showed the overall outlook to be in line with the year's budget.

##### **Using rolling forecasts to test if a plan is on track**

However, at this stage, a non-executive director (NED) was introduced to provide an independent view of performance. He pressed for the introduction of rolling forecasts. These showed that the new initiatives were leading to a growing level of underperformance against the plan with the risk of negative cash flows and a solvency crisis. In response, the NED and operations director developed an alternative plan which dropped the expansion initiatives but built growth incrementally around the existing business. This was presented to the PE syndicate independently of the CEO. After a period of disruption, during which the rolling forecasts started to be borne out in actual performance, and cash flow pressure developed, the PE syndicate accepted the alternative plan. The CEO exited and was replaced by the operations director, with the NED as chair.

##### **Outcome**

The new plan was implemented and the rolling forecast approach was extended to help identify those activities with good growth potential, and those that were potentially loss making. This proactive approach stemmed cash flow losses and set the company onto a path of profitable growth.

During the turnaround phase, cash flow losses placed pressure on the company's solvency. However, the implementation of the rolling forecasts reassured the PE syndicate. This enabled the company to raise short-term funding to cover the period of solvency pressure before returning to profitability.

## 7. INFORMATION INTERPRETATION DIFFERENCES AND BIASES

Actual and forecast performance results are collected by systems and then aggregated using the chosen analytical techniques (see Sections 5 and 6). They can then be evaluated against plans and targets (see Section 6) and presented in a way that will help management make performance decisions. Performance information is of no use unless it is understood and acted upon.

TENSIONS	SUGGESTED RESPONSES
<p><b>Performance information is difficult to interpret and subject to bias</b></p>	<ul style="list-style-type: none"> <li>• Treat variances as signals for action.</li> <li>• Regularly review your KPIs.</li> <li>• Keep financial analyses linked to operational actions.</li> <li>• Tailor BPM information to your audience.</li> <li>• Keep comparators relevant.</li> </ul>

### Information interpretation differences and biases - where you may see the tensions

#### Differentiating signal versus noise

It can be difficult to understand whether variances against plans have been caused by random noise (which occurs naturally in stable processes) or signal a real need to respond. For example, if we have ups and downs in sales from week to week it is difficult to identify a genuine trend on which we can base our actions.

#### Establishing cause versus effect

Even if we identify a real signal or trend, it can be difficult to distinguish cause and effect. For example, revenue being below target may have been caused by sales people not making enough client calls, but faulty assumptions may have led to unobtainable targets which have demotivated the sales team.

#### Automation leading to loss of judgement

While developments in information technology offer massive benefits for BPM, they can also distance decision makers from the numbers. Data is entered into systems, automatically analysed and churned out ready for decision making. This risks users not fully understanding the data, and losing the ability to make informed judgement calls.

### Bias in analysis and decision making

Human decision making is unavoidably compromised by biases, which means we cannot assume people always make logical decisions. This is comprehensively demonstrated by the work of Nobel Prize winner, Daniel Kahneman. Some of the biases that can occur in BPM decision making include:

- Numbers versus words. A preference for numbers over words may lead to a focus on financial measures at the expense of operational ones. Performance information may also be presented to decision makers purely in numbers, whereas some may find narrative information more useful.
- Process versus outcome. Rewarding financial outcomes can drive performance, for example through commissions based on sales. However, ignoring the processes and behaviours which cause performance may lead to the rewarding of luck and longer term problems such as a culture of non-collaboration.
- Accuracy versus usefulness. Too much time spent on perfecting the numbers can mean they are too late for decision making.
- Analysis versus intuition. A preference for analysis (potentially based on partial or changing information) can drown out the intuition of staff closer to operational activities.



- Fast versus slow thinking. Kahneman in his book, *Thinking, fast and slow* (2011), explored a common preference for fast, automatic, emotional, stereotypic and subconscious thinking versus that which is slow, effortful, logical, calculating and conscious. Confirmation bias, where we accept information that supports our beliefs and ignore that which does not, is also common.

### **Evaluation and presentation – suggested responses**

#### **Treat variances as signals for action**

Variances from plan are a signal for action rather than a cue to apportion blame. A useful approach is to categorise them as green, amber or red. This could be just a way of thinking and not necessarily a rigid classification. Green results are currently on course, although they should continue to be monitored as the situation (including the external environment) may change. Amber results exhibit uncertainty. Decide on a course of action (or decide to keep monitoring for a while), but build in options for change. Monitor performance and adjust your response as more evidence becomes available. Red results necessitate change. Usually a red flag indicates the need to respond quickly and purposefully.

#### **Regularly review your KPIs and KRIs**

KPIs and KRIs are only useful if they report how well you are meeting your strategic approach. If the market conditions, the organisation's key success factors, or its strategy change, then they will need to be updated. A good test of the relevance of KPIs and KRIs is to check if they are being used by management and staff to perform their roles, rather than as a post-hoc reporting activity.

#### **Keep financial analyses linked to operational actions**

We have already discussed how understanding the link between your key measures and their operational drivers needs to be understood. If this is not the case, then any responses you make are unlikely to be effective. Adopting a business partnering approach, with accountants who understand the operating model, will enable this link (see ICAEW 'Finance business partnering: a guide' 2014, [icaew.com/FBPreport](http://icaew.com/FBPreport)).

#### **Tailor BPM information to your audience**

Different individuals find information easier to interpret and act upon when it is presented in a variety of ways. Some will prefer graphs, some bulleted highlights, and others a more narrative approach. On a board, there are likely to be a variety of preferences. You need to get to know your audience and present information in the way that will be most useful for decision making.

Presenting your analyses in words, rather than restricting them to numbers, can also provide a more thorough review. Having to explain the ambiguities, uncertainties and assumptions in writing forces you to make sure you understand them.

Also, limiting the performance report to a manageable number of key measures and a concise length (for example, of between one and three pages), will ensure it focuses on what is important. Some of the report may be consistent each time to allow comparability (until circumstances or information needs change), and some of it will focus on the key issues at the time the report is issued.

#### **Keep comparators relevant**

Use the comparator that is most useful at the time. Using the initial budget to assess performance remains common and can be useful (although the Beyond Budgeting movement would deny this). However, as instability and change increases, fixed budgets become less and less useful and you may judge that using rolling forecasts is better. Also, consider judging performance by comparing it to last year's actuals where budget gaming is a problem.

**8. MISALIGNED INTERESTS**

**Multiple stakeholder interests**

Dealing with conflicting interests.

TENSIONS	SUGGESTED RESPONSES
<p><b>Multiple stakeholder interests versus the need for a clear strategy</b></p>	<ul style="list-style-type: none"> <li>• Use financial measures to provide clear, unifying goals. But beware of their limitations.</li> <li>• Continually test the strategy for fit to stakeholder aspirations.</li> <li>• Ethics, compliance and the law trump all other demands.</li> <li>• Personal or organisational exits are options.</li> </ul>

**Multiple stakeholder interests - where you may see the tensions**

**Conflicting demands**

Organisations have a diverse range of stakeholders, such as shareholders, funders, customers, suppliers, employees and regulators. These parties may have conflicting aspirations, which makes it difficult to define an organisation’s vision and mission and to agree a strategic approach.

**Evolving mismatch of stakeholder aspirations**

Over time, even stakeholder interests that were once well served by the organisation’s strategy can become misaligned. Stakeholders’ aspirations may change, as can their appetite for risk. Also, stakeholders whose relevance has decreased over time may retain excess levels of influence due to legacy structures and the established culture.

**Multiple stakeholder interests - suggested responses**

**Use financial measures to provide clear, unifying goals while being wary of their limitations**

Financial measures can provide clear goals, which are useful when working with diverse stakeholders. They are easily understood and communicated, plus they are widely accepted in the for-profit sector as the principal measure of success. However, used unwisely or alone, they have severe limitations, and in the public or not-for-profit sectors they would rarely be appropriate when viewed in isolation. They are best used in conjunction with operational measures and qualitative indicators to provide a comprehensive picture of organisational performance.

It is critical to maintain a clear view of the link between financial measures and the underlying operational actions that drive them (as we discussed in Section 2 ‘Operational and financial perspectives of success’ on p8).

**Continually test the strategy for fit to stakeholder aspirations**

The alignment of stakeholders' aspirations and an organisation's strategy should be reviewed regularly to avoid a mismatch evolving. The BPM information may be telling you that the original strategy is not achievable and needs to be updated, or a new direction may have naturally emerged. If so, does this new course fit in with stakeholders' needs?

When a mismatch is identified, act and communicate. If you assess that stakeholders' aspirations and the organisation's strategy are no longer compatible then action needs to be taken. Either the strategic approach needs to be adjusted or stakeholders need to reconsider their positions (see Case Study 5). Communicate unwelcome messages honestly. This may trigger accusations of failure and blame. However, if the stakeholders accept realistic aspirations then this can lead to a more successful outcome than if the mismatches are not addressed.

**Ethics, compliance and the law trump all other demands**

Sound ethics and compliance with regulations and the law are non-negotiable. Without them there is no likelihood of achieving long-term performance goals as there will be no future for the organisation.

**Personal or organisational exits are options**

Under some circumstances the best decision may be to exit or restructure the business. Potential purchasers or partners may be better placed to achieve what they and their stakeholders deem success. A personal exit is also an option if stakeholders are unwilling to listen to or act upon difficult messages.

## CASE 5: HEALTHCARE COMPANY

### Background

The organisation was a care agency providing services to local authorities, consisting of home visits to elderly and vulnerable patients. It was highly geared, having been built up through acquisition, using bank funding with a strict repayment schedule. The objective was to create shareholder value through growth in this highly regulated sector. This was underpinned by a culture of cost effective service excellence and BPM systems that monitored quality of service. The company had a wide mix of influential stakeholders, each with differing interests: shareholders (shareholder value), the bank (debt repayment), commissioning councils (high quality, cost effective care), care workers (work life balance and remuneration terms), clients and their families (quality care) and the regulator, the Care Quality Commission, or CQC (meeting regulatory standards).

### Trigger for change

Government austerity measures led to reductions in funding. This resulted in income reduction for the company, and reduced profitability and cash flow. Bank covenants were broken. Given the material change in market conditions, the company requested amendments to the bank covenants and repayment schedule. The bank did not accept this proposal and placed the company in special measures. The bank pressed strongly for management action to meet bank covenants and the loan repayment schedule.

### BPM was used dysfunctionally due to conflicting stakeholder interests

To meet these demands, management moved the principal focus of BPM towards meeting short term cash and EBITDA requirements, and away from service quality. For a while this approach was successful. However, this was achieved by cutting back on supervision and training for front line staff, and less use of BPM to monitor service quality. For example, supervisors spent their time managing rotas to ensure all visits could be made and maximum income generated. They neglected site visits, quality monitoring and training.

### Outcome

Over time, service quality degraded. The change in relative strengths of stakeholders had caused the company to divert from the initial aim of service quality. Visits by the CQC identified poor service levels. Care staff morale was low, leading to high staff turnover. Despite a range of underfunded patch initiatives, service levels and BPM processes failed to improve. This resulted in lost contracts and falling sales and cash flow, which forced the company toward insolvency. Eventually the business was sold through an insolvency sale of the reduced customer base, leaving all financial stakeholders, including the bank, with a significant loss.

This case demonstrates the failure of stakeholders to respond to changing market conditions (an uncertain world tension). The reduction in government funding meant that the business model on which the bank funding was agreed was no longer viable. Had the bank accepted this, and reduced their cash extractions, resources would have been available to support the continuing existence of a successful, albeit significantly less cash generative, business. This new model was accepted by the purchaser of the customer base, who was then able to invest in service quality, as the need to fund cash extractions to the bank had been cleared by the insolvency process.

**Misaligned staff interests, structure and culture**

Tensions which involve misaligned interests and staff capabilities are particularly common. They often occur in combination with other tensions, or exaggerate their effect.

TENSIONS	SUGGESTED RESPONSES
<ul style="list-style-type: none"> <li>• <b>Mismatch between staff and organisational interests</b></li> <li>• <b>Role interests versus organisational interests</b></li> <li>• <b>Dysfunctional reward systems</b></li> <li>• <b>Evolving mismatch between legacy culture and evolving strategy</b></li> </ul>	<ul style="list-style-type: none"> <li>• Use BPM to communicate the need for action.</li> <li>• Update plans to avoid dysfunctional behaviour.</li> <li>• Change staff, reward systems and structures if they become misaligned.</li> <li>• See crises as a burning platform to achieve culture change.</li> <li>• Embrace the CFO/CEO partnership.</li> </ul>

**Misaligned Staff interests, structure and culture - where you may see the tensions**

**Staff interests versus organisational interests**

Tensions occur when individuals’ interests become misaligned with those of the organisation. For example, while an organisation may set shareholder return as its primary target, employees may be more motivated by job security or securing their next career move. Also, intentionally or because of cognitive bias, staff may interpret results in ways that support their own opinions and interests.

**Role interests versus organisational interests**

Teams, departments and other structures within an organisation may develop interests that are misaligned to the whole. For example, a business unit head, or senior management of a subsidiary, may encourage achievement of local targets at the expense of those for the wider organisation.

**Dysfunctional reward systems**

Linking performance to reward can encourage dysfunctional behaviours. It can exacerbate the employee and role interest tensions discussed above, by encouraging the pursuit of performance related reward over organisational success.

Poor design of performance rewards has been linked to many cases of dysfunctional behaviours. For example, consider sales-team incentives based on revenue that fail to take into account profitability and risk, leading to sales teams being rewarded for bringing in customers that fail to pay their bills. A common problem is sandbagging where managers argue for conservative targets and forecasts to ensure they can beat them and obtain their bonuses.

Also, as financial outcomes depend on uncontrollable factors (such as the external environment), poorly considered assessment criteria can lead to unfair outcomes. Similarly, unfair use of performance management information to criticise an individual’s performance or justify poor wage increases (without giving staff the opportunity to provide input) can be demotivating.

**Evolving mismatch between legacy culture and evolving strategy**

Organisational culture develops over time in response to its historical context, expressed in deep rooted beliefs and assumptions. As demonstrated by Case Study 6, market changes and disruption may lead to a legacy culture that is no longer appropriate. However, as organisational culture can be very deep rooted, achieving the necessary change to a legacy culture to enable an effective response to market disruptions can be very difficult.

## **Staff, structure and culture – suggested responses**

### **Use BPM to communicate need for action**

Used well, BPM information can help you communicate the need for action to staff. Approaches such as KPIs, scorecards, colour-coding and rolling forecasts can be selected to suit the audience. Sensitivity analyses and scenarios can be used to explain uncertainties. Tailored information is more likely to make staff aware of the need to react immediately when quick corrective action is needed or to explain upside opportunities as stakeholder aspirations grow.

### **Update plans to avoid dysfunctional behaviour**

Update plans and targets when they become unrealistic, rather than waiting to fit in with pre-programmed planning cycles. Adjusting targets downwards when they become unachievable will reduce the risk of staff becoming demotivated. Conversely, raising undemanding targets could reduce complacency.

### **Change staff reward systems and structures if they become misaligned**

Even the most robustly designed practices can become misaligned, and the results of BPM may highlight that changes need to be made to staff, reward systems or the organisational structure.

**Staff:** Employees (including you) should be rigorously assessed on whether their skill set fits the demands of the role. Often the required skills will change over time, particularly when the organisation is growing, maturing, or struggling, such as in Case Study 6. Responses to underperforming staff include human resources performance management processes, training, development and coaching.

Even if individuals are capable, and share the interests of the organisation, time pressure may mean that they do not perform assigned tasks. Therefore management need to make tough choices, set clear priorities and allocate scarce resources appropriately. The BPM system should thus be an essential part of facilitating the alignment of individual tasks with the organisation's vision, mission and strategy.

**Reward systems:** Recognise the potential for reward systems to become dysfunctional over time and design them in a way that allows flexibility. Consider the balance of group versus individual targets, subjective versus objective assessments, fixed versus discretionary pay, rewarding behaviours versus outcomes and the proportion of carrot versus stick elements.

Also, consider the role of intangible reward systems and circumstances where it may be better not to perform formal measurement. In Dr Chris Ford's recent report for ICAEW, 'Business performance management: When not to measure', he considers situations where 'managers need to think very carefully about adding layers of measurement'. Such situations include circumstances where performance is heavily dependent on intrinsic motivation, where relationships are more important than transactions, or when innovation is a key goal.

**Structures:** As the operational environment evolves, the structure of the organisation may also become less appropriate. Changes to profit centres, business units and reporting structures can improve alignment with strategic intent. As with any change programme be aware that there will be resistance. Honest, clear and timely communication is crucial.

All decisions are based on judgement and are made under conditions of uncertainty. Beware of hindsight. Accept that if results indicate that another approach would have been better, that this does not mean it was necessarily a bad decision. A new evaluation should be made and actions taken.

**See crises as a burning platform to achieve culture change**

Culture change can take time when facilitated through new leadership behaviours, communicating the desired culture, inculcating new values, introducing new reward systems, recruiting new staff as people leave voluntarily, providing training programmes and so on. Crises can provide a burning platform to accelerate culture change. When the survival of an organisation is at stake and jobs are on the line, all employees may be more willing and motivated to change their beliefs and assumptions and work differently. Restructuring also allows organisations to make staff who are unlikely to adapt to the new culture redundant. Extensive changes to all aspects of BPM can also be introduced more rapidly to reinforce the desired culture.

**Embrace the CFO/CEO partnership**

When it comes to business performance, the role of the CFO, and their relationship with the CEO and other executives, is critical. CFOs are instrumental in extending the understanding of senior management. They do this by explaining the implication of financial results and linking them to operational activities. This is a skill that others in the organisation frequently lack, but is essential for informed decision making.

***Crises can provide a burning platform to accelerate culture change.***



**CASE 6: MANUFACTURING COMPANY****Background**

This privately-owned UK manufacturing company had traded successfully for many years and had a long term, highly experienced management team. It had a background of being debt free, property rich and of delivering good returns to its shareholders.

**Trigger**

Technology driven market disruption led to price and volume pressures, which threatened both profits and cash flow. Before this, the principal BPM activities of job estimating and production planning had been successfully performed within a context of stable pricing and market demand. Financial outcomes were confirmed by monthly and annual accounts, but there was no integration between estimating and accounting. The senior management team saw no reason to change this approach because of its long record of success. It continued to operate as if there had been no market disruption.

**The negative impact of staff with misaligned skills and interests**

Initially, the losses and negative cash flow were funded by borrowing secured on the property. This was based on management's assertion that the disruption was temporary. However, as debts mounted the bank became nervous and triggered the introduction of new management to support the existing team. The new management recommended changes, including:

- the introduction of lean processes to allow rapid and flexible responses to market demand;
- consolidation of production to one site; and
- a comprehensive restructuring of the job costing and production planning systems to provide accurate, real-time information to optimise the order-book value and allow the integration of operational and accounting sources to ensure the validity of information.

These proposed changes were resisted by existing management on the basis that the new team did not have the background and experience that they had. Also, they argued that their existing approach had stood the test of time.

**Outcome**

While some halting progress was made, the financial position continued to deteriorate to the extent that the opportunity to fund fundamental change was lost. The bank then pulled its security, leading to a forced closure of the company.



## *Conclusion*

In discussing the inherent and interrelated tensions in BPM we have highlighted the realities facing finance professionals seeking to improve organisational performance. BPM approaches which ignore these realities are unlikely to succeed. While the practical advice offered will help finance professionals deal with the challenge, each situation is unique and there is no substitute for a deep understanding of the business and high quality professional judgement. We have seen that understanding the business extends beyond understanding the links between strategy, operational performance and financial performance to include grasping

the impact of change and uncertainty in the organisation's environment and the implications of the differing interests of people involved in the business. It is through dealing with the tensions and developing 'good enough' BPM solutions that the finance function and finance professionals hone their judgement, demonstrate their effectiveness and add value to organisations.

We welcome comments on this report and in particular further case studies highlighting BPM tensions and practical ways of dealing with them. Please email us at [bam@icaew.com](mailto:bam@icaew.com).

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## ***About the author and acknowledgements***

The report's principal author is Dr Philip Smith, the co-authors are Emma Riddell and Rick Payne.

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Philip has over 30 years' business experience, at FD, MD, executive chairman, investor and advisor levels. He specialises in driving business performance improvement in private and private equity backed businesses across a wide range of sectors. In recent years, he has pursued a twin track research and practice career, following his completion of an executive doctorate in performance management from Cranfield School of Management in 2008. He is a Chartered Accountant, MBA and past chair of the ICAEW Finance and Management Faculty. He was principal author, along with Rick Payne, of the 2011 ICAEW report – *The finance function: a framework for analysis*.

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