SMART CONTROL

How to protect earnings with cash and cost programs

Stern Stewart & Co.

QVARTZ

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HOW TO PROTECT EARNINGS
WITH CASH AND COST PROGRAMS

Management Summary

It is not just since the financial and banking crisis of 2008 that market environments have been changing ever more quickly – driven by high levels of public debt in Europe, the crisis of financial and capital markets is once again spilling over into the real economy. Optimism and growth ambitions are increasingly giving way to uncertainty about the economic outlook and the associated caution regarding growth and investment intentions. Liquidity and costs are once again becoming focus areas for management.

Management responds to the volatile alternation of crises and upturns with major projects and programs aimed at enhancing flexibility and strength. However, the typical line organization of most companies is not prepared for this fast-paced change. The financial results of these programs therefore do not always meet expectations. Effective program controlling can prevent such shortfalls. We have identified seven principles that guide the establishment and firm rooting of effective program controlling within an organization.

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1. Define specific and measurable goals for each subproject 2. Develop action plans with tangible, measurable milestones 3. Measure performance vs. targets on at least three levels 4. Set dynamic targets 5. Retain knowledge and ensure neutrality 6. Use consistent data based on a program-wide software tool 7. Integrate program controlling into standard processes

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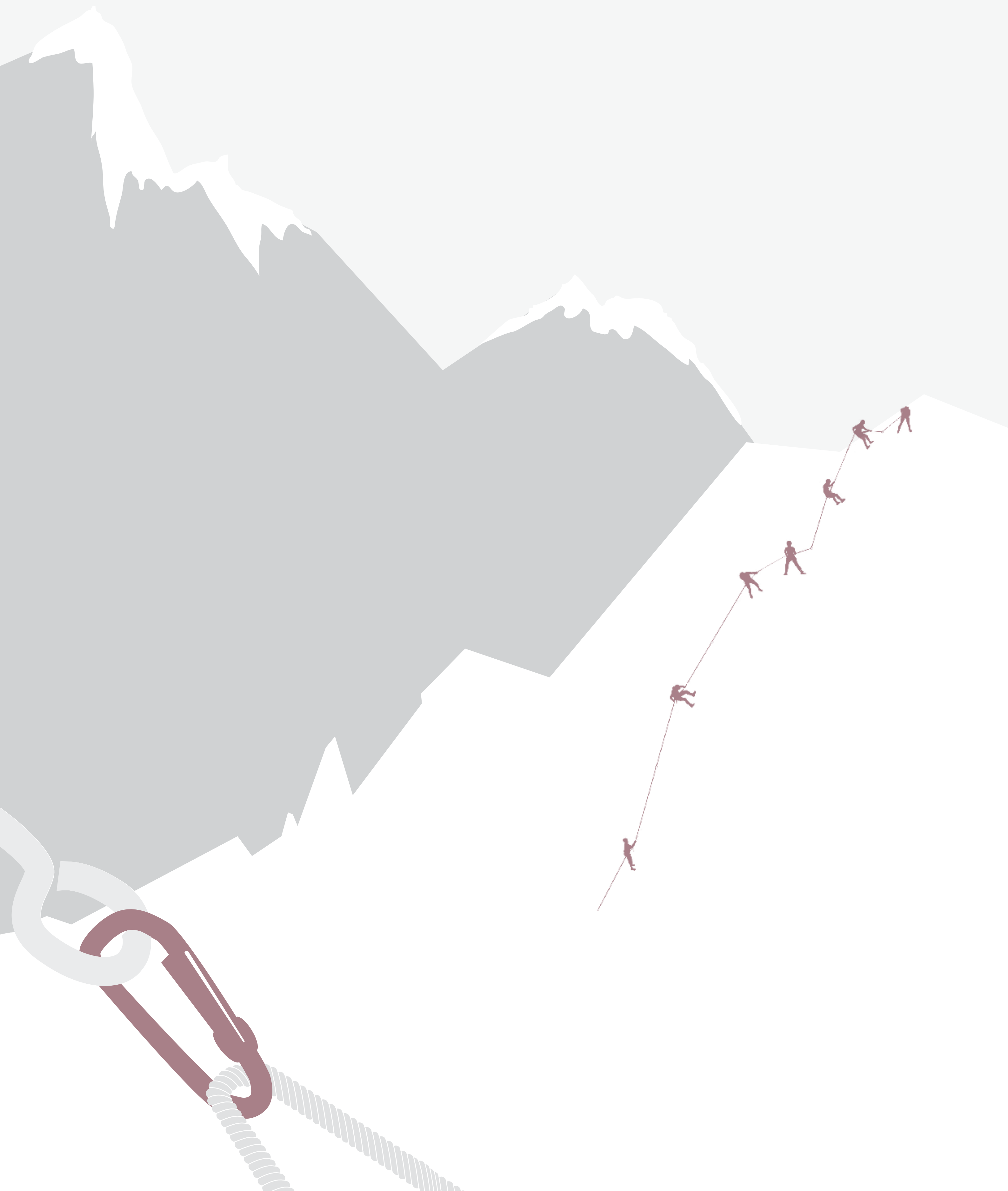

Introduction

80% of the DAX 30 companies run firm-wide projects on an ongoing basis. Within a just few years, initiatives are implemented that range from sales optimization to operational excellence and finance agenda 20xx. Often, IT platforms are harmonized in parallel. The goals are almost always to boost revenues, cut costs or increase capital efficiency. However, the long-term results of many projects lag behind the expectations set in the original initiatives.

Many managers will be familiar with the following situation: A project is set up, a concept is prepared, the agreed measures are implemented, and those involved in the project are celebrated for its success; and yet in the next reporting cycle, the promised effects fail to materialize in the P&L and balance sheet. The situation is often complicated further by several excellence initiatives running simultaneously, the effects of which cancel each other out.

In the last crisis, it became apparent how important it is to truly realize the intended effects. Companies addressed issues like costs and liquidity, but more often than not the courage was lacking to make really radical changes and the measures ultimately taken were limited to isolated aspects pertaining to day-to-day business. Furthermore, they failed to adequately monitor the implementation or see it through to the end, because the upswing that followed the financial crisis re-focused management attention on growth initiatives.

Now, economic indicators are looking bleak again. The IMF notes that: "The global economy is in a dangerous new phase. Global activity has weakened, confidence has fallen sharply, and downside risks are growing." For 2013, the IMF expects real GDP growth of a mere 0.7% for the Eurozone. Worldwide, a moderate 3.9% is forecast, accompanied by ongoing high volatility in the finance and capital markets.

Given this environment, cost efficiency and cash build-up will return to the center of attention. Management will call for new initiatives on operational and financial excellence. Effective and consistent program controlling ensures that the planned effects of those initiatives really do translate into tangible profit. Almost as with the measurement problem in quantum mechanics, the effects of large initiatives only become apparent with consistent measuring – with program controlling.

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Take control of the effects and anchor them in the line organization with seven rules:

1. Define specific and measurable goals for each subproject 2. Develop action plans with tangible, measurable milestones 3. Measure performance vs. targets on at least three levels 4. Set dynamic targets 5. Retain knowledge and ensure neutrality 6. Use consistent data based on a program-wide software tool 7. Integrate program controlling into standard processes

Principle 1:
Define specific and measurable goals for each subproject

The main purpose of program controlling is not to determine specific target amounts, even though this may become an additional task in the long run. In order to initially set up program controlling in such a way that it ensures adherence to targets, it needs to focus on two key aspects of target setting: First, strictly delineate goals among individual subprojects, and second, clearly define the starting level (basis) to ensure proper quantitative progress tracking.

So-called maps ensure that the targets of individual subprojects do not overlap. In order to realize effects, it is crucial to know where the effects are to be realized. Using a map solves two problems: The areas in the company that have not been impacted by the process are identified, while at the same time the effects remain definable even with a high number of projects.

Savings goals should be assigned to claims on the map even during the target-setting process. A claim on a cost map is, for instance, defined in a matrix consisting of cost types and departments. For the travel & entertainment/sales claim for example, using the target map prevents any overlap between measures as early as during the target-setting process. Particularly when a number of projects are running simultaneously, situations can otherwise arise where individual projects are attributed with effects they did not cause. By setting clear boundaries on the effect map, such double counting is avoided.

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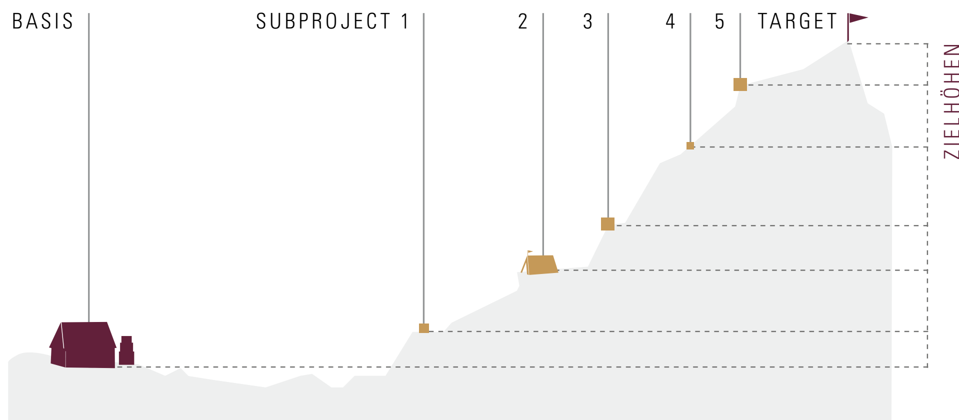

FOCUS:
A CLEAR BASIS AND UN-AMBIGUOUS TARGETS FOR SUBPROJECTS ARE KEY

Holistic target setting includes having a clear definition of the basis in addition to a location on the map. Numerous programs designed to increase efficiency have shown that target achievement can only be reliably measured on the basis of actual values. If targets are set relative to a plan, budget or forecast, ample experience has shown that the results do not materialize in the actual financials. The first reason for this is that a revenue increase relative to plan can just as easily mean a drop in actual turnover. Likewise, cost savings vs. plan can hide a cost increase.

COST MAP		COST TYPES (BU / REGIONAL)						
		Personnel				IT infrastructure		
FUNCTIONS (ON DIVISION / LEVEL)		Internal Direct	Indirect	External Fixed	Variable	Mainte-nance	Licen-cing	…
Accounting	General ledger							
	Asset Mgmt							
	Creditors							
	…							
Controlling	Strategic							
	…							

Distinguishing costs across all divisions

MAP OF EFFECTS:
TRANSPARENCY OF EFFECTS ACTUALLY ACHIEVED BY AVOIDING DOUBLE COUNTING

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The second and often more relevant reason lies in the present-day reality many companies face. Often, a budget or plan is adopted that includes certain measures. Due to the complexity of most corporate plans and intiatives, at the next plan update the measures that have already been included can no longer be distinguished from those which have not. For group planners, the combination of planning and initiative tracking vs. plan becomes chaotic, and this becomes a loophole for the operating units. Who still remembers at the half-year mark which plan version was the right basis for evaluating an inititaive? So, as a take-away, always track implementation progress against actuals. This is of course apart from the need to embed initiatives into the overall plans to make sure they take root in the organization.

The best basis for setting targets for initiatives is the annual financial statement. With it you have a firm basis not only for the legal entities, but also for the segments.

Even if both of the aforementioned rules are taken to heart, it is often necessary to consolidate effects to reflect internal production and support processes. In order to avoid double counting in operating and shared services units, effects are calculated according to the primary cost principle. This involves the operating unit informing the shared services unit of its savings potential. The shared services unit reviews the initiative and assumes ownership based on the effective savings. Finally, the consolidated net savings potential has to be allocated to the individual units. Just how this offsetting is done is often not decided by program management, since whether one is dealing with a cost center or a profit center is not driven by the program. However, program controlling has to ensure that the right allocation method is used. In many companies this process is complex and opaque.

Principle 2:

Develop action plans with tangible, measurable milestones

It has become common practice to identify initiatives to reach project targets. The meaning of "initiative" is less clear, however. The purpose of defining initiatives is to reach the project target by breaking up the process into implementation steps containing specific actions. These should be clearly attributed to an individual, divided into milestones and linked to measurable effects.

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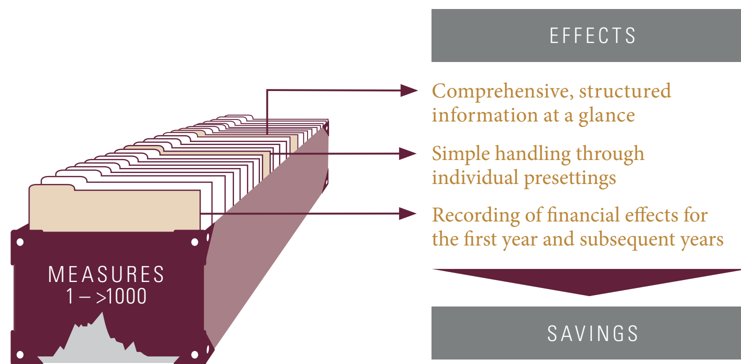

MEASURE TOOL: CONSISTENT MANAGEMENT OF MULTIPLE MEASURES

In the case of major projects with savings in the triple-digit millions, for instance, it works best to formulate initiatives only upward of a cost effect of EUR 100,000. For one thing, the effects of an individual measure still have to be traceable, and for another they should comprise well defined, specific implementation steps wherever possible. Between 1 ->1,000 measures is hence the norm for major projects, and they can also easily be handled with the appropriate tool.

What becomes clear in the process is just how important a common, disciplined definition of the individual initiatives is. With over 1,000 measures, there can be no room for interpretation. One could conclude that it is merely about the technical side of implementing a program, but consistently defined measure maps and a consistent, company-wide measurement tool are key structuring aids.

By stipulating consistent initiative maps, program controlling specifies key mandatory fields. One example is the mandatory entries of profit/cost centers to generate a measure map, meaning to include it in the assessment. This significantly simplifies the subsequent controlling of the effects via the cost center in question.

When implementing each initiative it should be noted who is in charge, which milestones have to be met and what costs it saves. Each measure can be tracked in terms of whether the milestone was adhered to and if the promised savings actually materialized in the unit. Standardized measure maps guarantee that one never loses sight of things, even in large programs.

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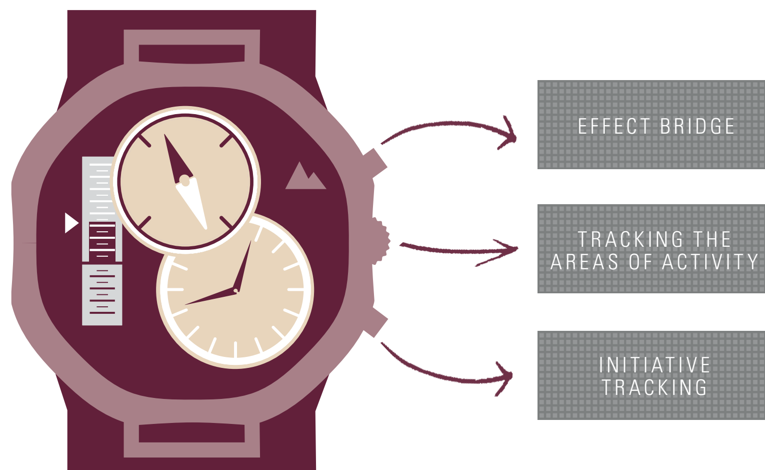
Principle 3:

Measure performance vs. targets on at least three levels

Performance is often measured in a very granular way based on KPIs at the level of individual initiatives, and at a very high level based on group reporting. But the two do not go together. In order to ensure that the effects materialize, stringent tracking is necessary that monitors the absolute target values - and not the KPIs - and that includes reconciliation across at least three levels.

CONTROLLING ON 3 LEVELS: THE HEART OF PROGRAM CONTROLLING



Level 1: Effect bridge and division level

The heart of program controlling is the effect bridge at the business area level. It shows management whether the effects are actually going to appear in the financial statements. Starting from the defined basis, structural effects and offsetting effects are added. The effects of the program, namely those from the initiatives, are quantified and compared with actuals. If the result is in line with the target, there is no need for action. But if there is a gap, it becomes immediately apparent that an explanation or additional initiatives are required.

In this way, management keeps up to date on progress vs. targets and potential adjustment needs at business area level. This bridge view can also be prepared on a consolidated, group-wide level.

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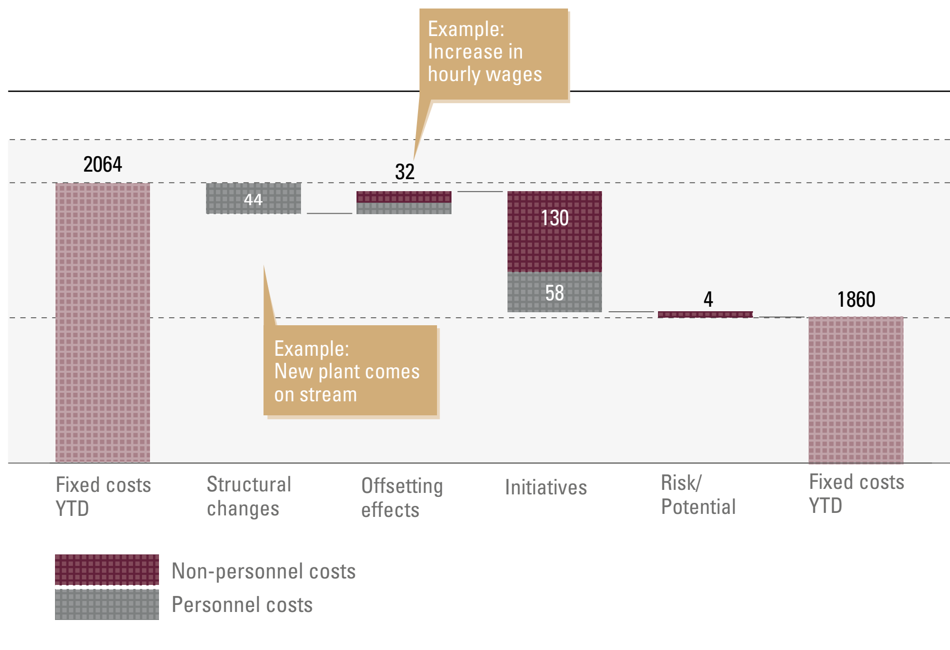

EFFECT BRIDGES: MEASURES AND EFFECTS AT BUSINESS AREA LEVEL

Level 2: Tracking areas of activity

Tracking at the level of areas of activity shows whether the effects materialize as planned. If, for instance, a target was set to reduce maintenance costs, the savings should also be achieved in this area of activity. The effects of the initiatives are allocated to the respective areas of activity. The easiest way to do this is via cost-type accounting. If certain areas of activity impact multiple cost types or are a partial proportional combination of cost types, initiatives may be attributed individually to the respective areas of activity (e.g., personnel cost as part of said maintenance cost reduction).

If a target is not reached in a given area of activity, adjustments can be made. This is especially helpful if certain areas are to be optimized further beyond their contribution to the overall goal.

Level 3: Initiative tracking

Initiative tracking is the most granular level of program controlling. It ensures that individual initiatives are actually implemented and their planned potential is realized. To this end, it is necessary to track the implementation of the initiatives in detail.

In many projects it has become apparent that it takes tracking on at least three levels to ensure the realization of savings targets. The three-layered approach is at the heart of program controlling. All that follows serves to refine the approach, to make it compatible with a changing environment and to embed it in the organization.

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Principle 4:
Set dynamic targets

The effect bridge is the basis for dynamic target setting. It allows for the program targets to be continually adapted to changes that arise at short notice. This concerns in particular the offsetting of effects such as implementation costs and increases in factor costs.

During the implementation of the program, target amounts are put to the test by dynamically comparing the offsetting effects, the achieved potential and the target values. The high degree of transparency which results from the clear allocation of targets, standardized initiatives and effect tracking makes it possible to carry out nuanced readjustments in individual subprojects.

The key instrument for this is the business case for program controlling. The business case is comprised of information obtained from company reporting like the P&L and balance sheet, the effect bridges of the subprojects and their targets. Right away it becomes apparent if the set targets can be reached or if there is a need to readjust. The key here is for the business case to properly depict the internal view and, at the same time, to include external parameters in such a way that makes it possible to forecast scenarios. The result of the simulation is that management gains an overview of possible scenarios, and hence the information it needs to adjust the program and the targets.

Principle 5:
Retain knowledge and neutrality

Program controlling is often handled by a temporary project office. In most cases, the project office is made up entirely of external consultants. Over the long-term there are three weaknesses inherent in this:

First, from the standpoint of the company as a whole, the project office is not neutral. Controlling within a project is absolutely necessary, but will not objectively challenge the success of the project per se.

Second, there is no all-encompassing view of all the projects running company-wide over a longer period of time. As a result, overlapping projects and potential utilization are not fully recognized by the project office. This usually results in multiple ill-coordinated claims on improvement potential flowing into group steering.

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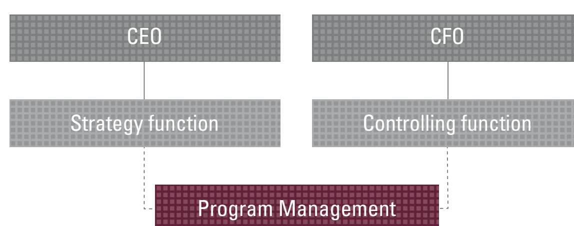
Third, the company runs the risk of losing knowledge. Any industrial group will typically run multi-year sales optimization, sourcing excellence, finance 20xx and IT harmonization initiatives alongside its business as usual, as well as short-term earnings and cash generation programs. Each project will have its own program/project controlling instance, and the overall perspective is not maintained. The projects usually rely on external support, and while knowledge of the content of individual projects is usually transferred as part of the project handover, the aspect of program knowledge is often neglected.

Companies that concentrate this meta-knowledge in a dedicated department on an ongoing basis and over the long term have realized significant efficiencies when carrying out projects. Existing projects are consistently seen through to the end, potential for improvement actually materializes in the financials and new projects do not overlap with existing ones.



ORGANIZATIONAL IMPLEMENTATION: INTEGRATION AND RESPONSIBILITIES IN JOINT PROJECTS

PROGRAM CONTROLLING TASKS

- Approving target maps from operating units
- Reporting on potential and results for each measure and subproject
- Identifying gaps in target achievement
- Initiating measures to reach targets
- Clarifying responsibilities between projects and operating divisions
- Escalating conflicts between projects and operating divisions

Three rules have proved their worth when establishing a permanent department for program controlling: First, use a large program for its pragmatic introduction. Second, there should be a gradual transition of three months from external support to internal resources. Third, specific training is needed to convey program controlling techniques and approaches to internal staff.

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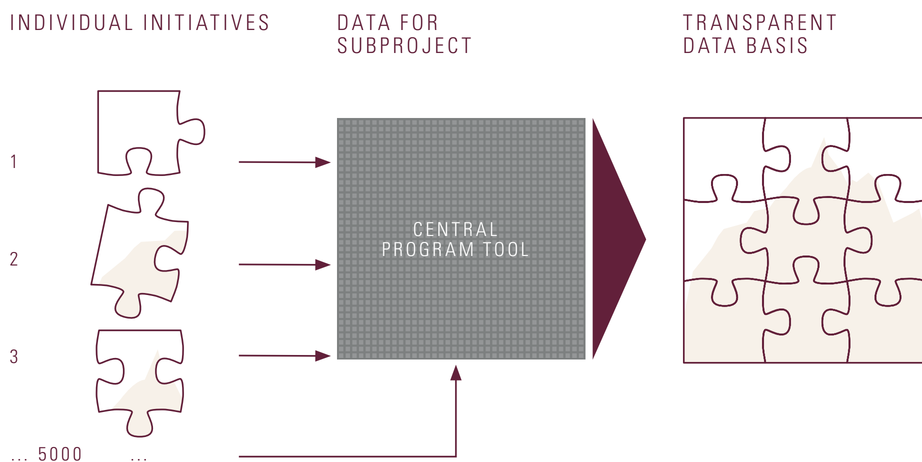
Principle 6:

Use consistent data based on a program-wide software tool

Reporting within program management relies on the same prerequisites as company reporting, but it is mostly neglected. Initiatives are defined in each project, and every company has a range of tools to process and track them. And therein lies the problem: What is needed is a company-wide master tool which dictates the truth in program controlling.

The two key criteria are transparency and consistency. And just like in group reporting, which has a consistent reporting tool, the solution for program management is a consistent tool as well.

TECHNICAL SUPPORT: CONSISTENCY INCREASES PROBABILITY OF SUCCESS



Transparency means that the numbers for each subproject are reflected in the overall program reporting. Ideally, subproject targets and actuals can be directly aggregated to the program. Otherwise, a reconciliation from subproject to program level is necessary. Failure to provide this reconciliation is a serious disadvantage, because transparency is key to generating the buy-in of the operating units. Having the operating units buy into the central program reporting is the best way to avoid arduous coordination sessions.

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Consistency is the second element that reduces the need for coordination. If numbers are transparent to everybody, and a master data record is used in a central tool, variances vs. targets no longer triggers discussions about data quality, but rather about the actions that are required on the basis of the data.

For companies with extensive and ongoing projects, an overarching program-reporting tool covering all three levels of program controlling is therefore indispensable. A tried and tested tool as shown above covers the entire process from logging the measure in the operating units, to effect tracking, right up to dynamic target setting in the business case. As a result of this end-to-end view of program controlling, breaks are avoided and interfaces minimized.

To ensure neutrality, the department for program management should be the keeper of the data in the program tool.

Both transparency and consistency are key success factors in program controlling. They can be achieved with a group-wide tool.

Principle 7:

Integrate program controlling into the standard processes

There are two reasons for integrating program controlling into standard processes: It ensures that the actual state of individual projects is incorporated into group-level steering and it facilitates action-orientated management.

Programs geared to increase efficiency are not an end to themselves. Their effective impact on the company is often hard to assess beyond general potential estimates. Cost programs are a typical example: Compared to the previous year, EUR 300 million in fixed costs are supposed to be saved. The latest forecast shows that current efforts will not suffice, so business areas are called upon to provide new initiatives. Now, will those new initiatives really be new? Or were they already included in the forecast? An integrated approach provides answers to these questions.

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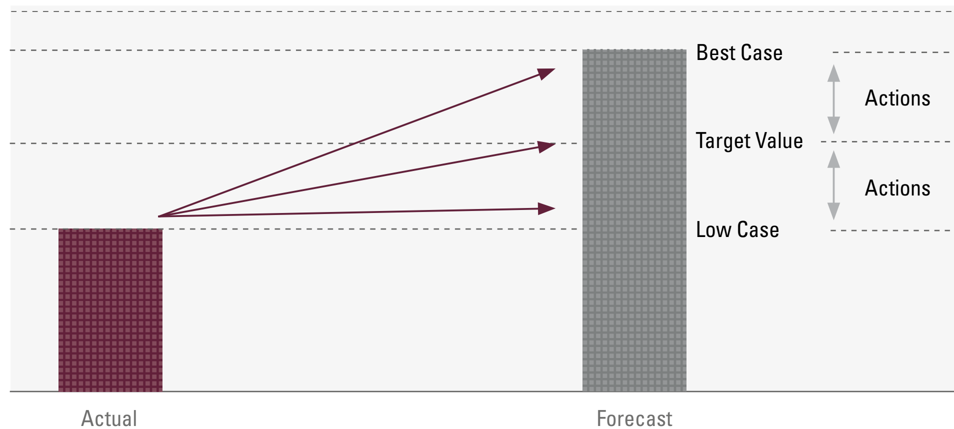
FLEXIBLE MANAGEMENT OF INITIATIVES: BASIS FOR DECISION-MAKING & ACTION IF THERE IS DEVIATION FROM TARGETS



Incorporating the management of initiatives into group steering allows even large conglomerates to react flexibly to market trends. Especially at a time when forecasts are uncertain and forecasting has to be based on scenarios, initiative management offers the necessary flexibility for the firm to position itself in accordance with the scenario. However, integrated program controlling is also required if initiatives are to be implemented sustainably. The financial crisis clearly showed this.

Integrating program controlling into the standard processes of the finance function mainly involves three central finance processes: reporting, planning and forecasting. The integration removes the need for shadow accounting for projects. The double counting of initiatives is just as much a thing of the past as the uncertainty surrounding the current status of initiatives.

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Realizing planned improvements with the seven principles of program controlling

Changes in the market environment are more frequent today than ever before. Through project management, companies can react flexibly to them. Many large-scale programs are launched for this purpose, but actually realizing the expected potential requires consistent program controlling. The now common initiative-based projects were the first stage in the evolution of program management. But the most efficient stage can only be reached by linking program controlling with the line organization and standard processes.

The seven principles of program controlling have proven themselves in numerous companies by actually realizing planned improvements.

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