Re-aligning steering, enabling change

In economically challenging periods, companies all over the globe reshape their businesses and overhaul operating models. A re-aligned steering model empowers organizations to cope with the changes successfully, and it ensures effective decision-making.

Times of crisis are times of change. When external factors upend markets, it is critical for businesses to adapt quickly in an appropriate manner. However, if you re-configure your current business operating model, for example, processes, organizational structures, or collaboration rules, you then also need to alter your steering approach. The aim is to make it fit for steering the performance of your changed business, be it in good market phases or in more challenging ones. In periods of acute economic stress, such a re-alignment of the steering model is a matter of strategic urgency. It should be addressed at the board-level to make sure the initiative has the necessary organizational clout. In this issue of CFO Insights, we will discuss the factors that contribute to the need for change and suggest measures that we deem helpful for re-aligning each of the steering model's four main components: steering objects; charging and allocation; KPIs; and managerial financial statements.

The CFO Program

No business as usual: Impacts, measures, implications

In times of economic upheaval, most companies witness fundamental change in consumer behaviors, market demands, and supply chain aspects, much of which may well turn out to be permanent after the crisis has come to an end. Such trends are also likely to accelerate the pace of digitalization even more than is already the case. If you have a look at how businesses respond, three typical decisions stand out; often, more than one of these are taken simultaneously. First, companies typically react with initiatives such as reorganization, supply chain changes, or restructuring, aiming to improve cost efficiency and to prepar the business for future growth. Second, many organizations increase the focus on new (often digital) business models, catering to projected change in demand and user preferences and at the same time unlocking cost savings with the help of digital enablers. Third many companies opt to concentrate on core activities and expand the most attractive business models within the company's portfolio, often through acquisitions and divestitures. All three decisions have at least one thing in common; they require a re-alignment of steering mechanisms to ensure effective decision-making. As a side note, a steering model re-alignment can have additional benefits, as it is a key requirement and the basis for ERP transformations that many corporations are about to embark on at the moment. A precisely designed steering model clearly has to be in place before structures and business processes can be operationalized in the ERP setup. Assuming that the necessary changes to the business in one or more of the aforementioned areas have been determined, how can you then re-align your steering model's components in the most stringent way?

A matter of clarity: Steering objects and focus

The first aspect is the definition of steering objects in a clearly structured hierarchy. These steering objects should correspond to your adapted business operating model, in particular the organizational structures. You will need to decide on the perspective from which you will steer, the leading primary view on board responsibilities, and management units for core steering processes, such as target setting, capital allocation, and performance tracking. For example, a mobility service provider defined the following steering objects along its value chain: Sales, Traffic Planning, Vehicles, Infrastructure, Driving Services, and supporting Service Processes. Each of the objects was clearly delineated with a specific steering focus based on the organizational responsibilities and individual ability to control key performance aspects. The focus should include major controllable elements, both financial and non-financial. This ensures that you can assign financial accountabilities (e.g., for profit and loss items) to the objects in a precise and efficient manner. At the same time, the steering objects represent the basis for group-wide standardized profit and cost center structures. When designing steering objects, it is also important to heed external requirements. For instance, consider the regulations in IFRS 8, which require certain entities with publicly traded securities to disclose information about operating segments.

Foster effectivity: Charging and allocation

When addressing charging and allocation aspects, your overriding aim is to encourage effective transactions between steering objects, such as the delivery of physical goods or the provision of services. One major factor for achieving this is finding the right trade-off between accuracy and simplicity. Cost charging and allocation principles should provide guidance, be consistent and incentive-compatible, and ensure that transaction costs remain reasonable. It is essential to design these principles to be as transparent, comprehensible, and simple as possible. As a real-world example, an automotive supplier developed principles, such as a rule that all charging between steering objects should be cost-based, a rule that there should be a mark-up for inter-company transactions for legal reasons only, and a basic rule to waive charging within the holding function. The baseline for cost-based charging consists of plan-based costs and actual consumption wherever applicable. We advise developing such principles in a joint effort between the business and the finance experts and ensuring that all external reporting requirements are satisfied. For instance, you should take into account existing tax regulations regarding transfer pricing when determining charging and allocations for inter-company transactions in the group.

Getting a grip with balanced indicators: Selective KPIs

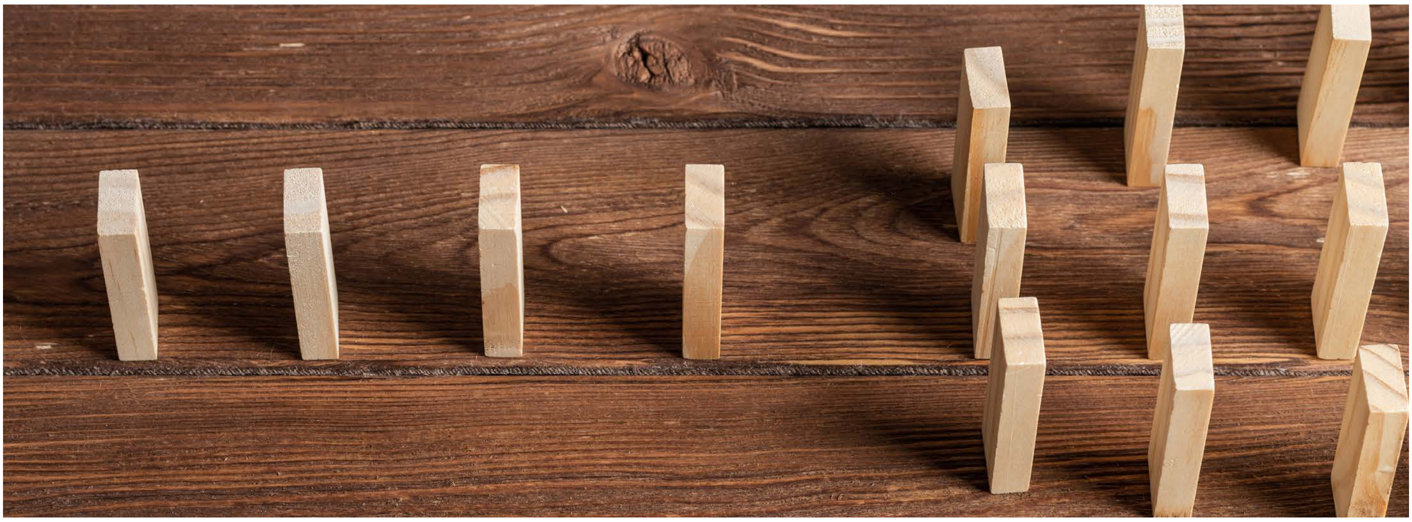
For group steering purposes, an effective top KPI set is paramount. In order to make the right decisions, you obviously need to measure the right things. A carefully selected KPI set with a forward-looking profile should cover both core and new businesses align with the organization's overarching purpose and strategy, and relate to aspects such as growth, profitability, asset efficiency, and sustainability. To adequately cover these objectives, the KPI set should not be limited to financial KPIs but should sufficiently incorporate non-financial KPIs as well. The selection should ensure comprehensive transparency on overall group performance but balance this at the same time with a clear indication of key contributions of individual value chain elements, that are functions such as research and development, procurement, production, or sales. The combination of group-level and function-level KPIs enables an integrated steering approach, as it reflects interdependencies between individual steering objects (e.g., functions) and the overall group. The top KPIs of individual functions should represent their most material levers with regard to group performance. For steering at the function-level, additional specific operational KPIs will be used.

The case of a global automotive OEM provides an instructive example of what such a selective KPI set could look like as a part of a re-aligned steering model. On the one hand, the set provides an overview on overall group performance via well-selected KPIs on top-line growth, profitability, asset efficiency, and cash and liquidity considering the capital market view. On the other hand, the KPI set creates transparency of the contributions of individual functions and performance interdependencies by including function-specific KPIs. For example, for Production, the focus is on manufacturing costs, efficiency (such as manufacturing hours per vehicle), and quality, while for Sales, the focus is on sales volumes, market share, price realization, and inventory-levels.

When designing KPI sets, it is again important to keep an eye on external regulations, such as German Accounting Standards concerning the group management report (GAS 20/DRS 20) with its prescriptions about performance indicators.

Ensure clear mapping of financial accountability: Specific profit and loss, balance sheet, and cash flow statements

The clear definition of steering objects as the basis for a re-aligned steering model is also reflected in the improved design of the financial statements that are regularly used by management to steer the organization's performance. For instance, specific profit & loss (or contribution margin) structures make it possible to take an individual view on each steering object, based on controllable aspects of the financial performance. EBIT may be steered at the group-level, whereas individual accountabilities for EBIT drivers should be clearly assigned to objects across the organization. For individual steering objects, more specific line-item break downs can be provided in individual profit & loss statements, depending on accountability. For example, an international mechanical and engineering group assigned individual profit & loss drivers to steering objects, such as Sales, Operations, and Technology. At the same time, the Group Management profit & loss provided the complete view on profitability and integrated the accountabilities of other steering objects. These principles were applied not only to profit & loss statements but also to balance sheets and cash flow statements.



Steer for more impact: The case of a global manufacturing company

Deloitte experts have helped a variety of clients with re-aligning their steering model. An example from the manufacturing sector can shed some more light on what that amounts to in practice. The client's situation was quite challenging. It was clear that changing industry dynamics will significantly shift the nature of the business, including increased competition and price pressure. To extend the leading position in key segments, increase economies of scale, and access new markets, a competitor had been acquired. However, a variety of issues showed that the current way of steering was not ideally suited to the upcoming challenges. The existing model was dominated by tax aspects, but this tax orientation was experienced as a burden. It increased complexity too much and generated ineffective management dialogues. In addition the general EBIT focus for business units and regions that were organized in a matrix promoted local optimizations, while failing to address and unlock group-wide synergies. With this setup, the right decision might get to be questioned several times due to local profit & loss impacts. On top of that, too many cost allocations between the steering objects meant that many unproductive arguments about the validity of reported performance figures ensued, distracting from the resolution of actual business issues.

What was the way forward? The answer was a simplification and standardization of decision and steering processes. The solution included the development of a new business operating model with aligned organizational structure and simplified collaboration rules. The steering model was re-aligned accordingly to provide group-wide cost transparency with clear financial accountabilities. These measures ultimately enabled faster and more customer-centric market activities. The new model was operationalized in redesigned core finance and controlling processes, including planning, forecasting, and management reporting. This was grounded in sharpening supporting transactional finance processes–such as profit center accounting, product calculation, and consolidation–and the respective finance IT architecture. The simplification and optimization of finance and controlling activities resulted in a better collaboration, more efficient processes, and increased transparency through a shift to a managerial view in steering.

Ready, set, go: How redesigning your steering model can work out in three steps

When you are under economic pressure, adjusting your company's steering approach becomes a top priority once you have envisaged the necessary changes to your business operating model. The good news is that with the right approach and commitment such a project can be realized very quickly. Our experience shows that a three-step approach in a timeframe of several weeks is sufficient. Deloitte experts typically devote the first phase to setting the direction, for instance in top management and expert interviews and a guiding principles lab. In the second phase, the target picture is designed, including steering objects, charging and allocation principles, top KPIs, and managerial financial statements. Ongoing labs and top management alignments secure the integration of essential know-how from within the organization and a strict focus on stakeholder requirements. The third phase is dedicated to preparing implementation by analyzing the impact on finance and controlling processes, methods, data, systems, and organizational aspects; developing an integrated roadmap; and mobilizing the organization. Importantly, a variety of critical success factors need to be met before and during the project. First, alignment regarding the business operating model has to be established. Second, the re-alignment project requires key CxO involvement to shape a visionary steering model top-down. The extent to which current steering processes need to be changed must be agreed on, and the steering model needs to be kept reasonably simple, while ensuring that it creates strong performance impulses. Third, it is important to stay focused on the joint objective of raising overall organizational performance even if the re-alignment may conflict with certain individual interests. Honoring these success factors will not only accelerate the steering model re-alignment but also increase acceptance in the organization. The re-aligned steering model sets the basis for your organization to make the changes to its business operating model a success, whatever direction the economic development will eventually take.

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