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FINANCIAL PLANNING & ANALYSIS AND BUSINESS PERFORMANCE MANAGEMENT

CHAPTER INTRODUCTION

Financial Planning & Analysis (FP&A) and Performance Management (PM) are critical functions to the success of any enterprise. In this chapter, we will define what we believe productive FP&A and PM functions should include, and we will preview the contents of the remainder of the book. We will use the terms FP&A and PM interchangeably to encompass these two related and overlapping disciplines.

THE PROBLEM WITH TRADITIONAL MEASUREMENT SYSTEMS

Traditional financial reports have several limitations. First, they typically are prepared after the close of the accounting period, on a monthly, quarterly, or annual basis. Once these reports are prepared and distributed, managers attempting to use them for performance monitoring are looking in the rearview mirror. The report may tell them where they have been, but it will not be helpful in keeping the car on the road! A financial report for March, for example, may indicate that inventories increased above expected levels. While management can review causes of the increase and take corrective actions in April, they were unable to avoid the problem and are left with the unfavorable impact on working capital and cash flows.

A related limitation with traditional accounting reports is that their content is typically focused on "lagging" financial measures, such as gross margins, days sales outstanding (DSO), and so forth. Effective managers identify "leading" indicators of critical processes and activities that can be monitored on a current basis. This affords them the opportunity to identify exceptions and unfavorable trends and take immediate corrective action. In creating a system of effective performance improvement reports, managers need to identify the leading or predictive indicators of performance. For example, a key but lagging indicator of accounts receivable performance, DSO, requires knowing the ending receivables balance and sales for the period. However, a well-constructed performance report will track key leading indicators such as revenue patterns and collections on a weekly basis throughout the quarter. Management can estimate the ending receivables level based on the interim measures and take corrective action immediately *within* the quarter if exceptions or unfavorable trends emerge.

The third limitation with most accounting reports is that they are prepared by accountants in a way that is useful and intuitive to them, but is difficult for most nonfinancial managers and employees to understand and digest. These include traditional financial statements, supporting schedules, and spreadsheets that are easily understood by accountants, but can be confusing to the rest of the organization. Key trends or exceptions may be buried in the statements, but are extremely difficult for anyone to identify, let alone take action upon.

Another challenge is the endless bombardment of new financial measures and new management disciplines over recent decades, including economic profit, scorecards, key performance indicators (KPIs), dashboards, data visualization, analytics, and artificial intelligence (AI). In addition, performance measures have been developed for specific industries and special situations such as early-stage enterprises. Managers should look across these various initiatives and extract and combine the best features of each to develop an effective system of performance management for their enterprise.

OBJECTIVES OF FINANCIAL ANALYSIS AND PERFORMANCE MANAGEMENT

Figure 1.1 presents the instrument panel in the cockpit of the space shuttle. At a glance, the pilot can get a highly visual report on the shuttle's altitude, on its attitude, and on every major system in the aircraft. The radar in an airplane allows the pilot to spot and identify potential external threats long before visual contact. At first the panel appears very complex, but you can bet the pilots know where every needle and dial should be and the importance of any changes! They compare this information with the feel of the plane, visual observation, experience, and intuition to make adjustments in real time, as indicated, to operate the craft in safely executing the flight plan or mission.

In a nutshell, the objectives of FP&A and PM are to develop and provide information to run the business and achieve the organization's goals, just as the instrument panel assists the pilots of an aircraft to execute their mission.

Our definition and application of FP&A is very broad and inclusive. It includes all activities that assess, plan, improve, and monitor critical business activities and initiatives. PM is a critical aspect of the management processes of the enterprise. Performance management is closely aligned with and overlaps FP&A in many respects. Important characteristics of effective PM include:

- Achieving an organization's goals and objectives, including strategic and operational initiatives, forecasts, and planned results.
- Projecting and modeling future financial performance.

FIGURE 1.1 Space Shuttle Cockpit Instrument Panel

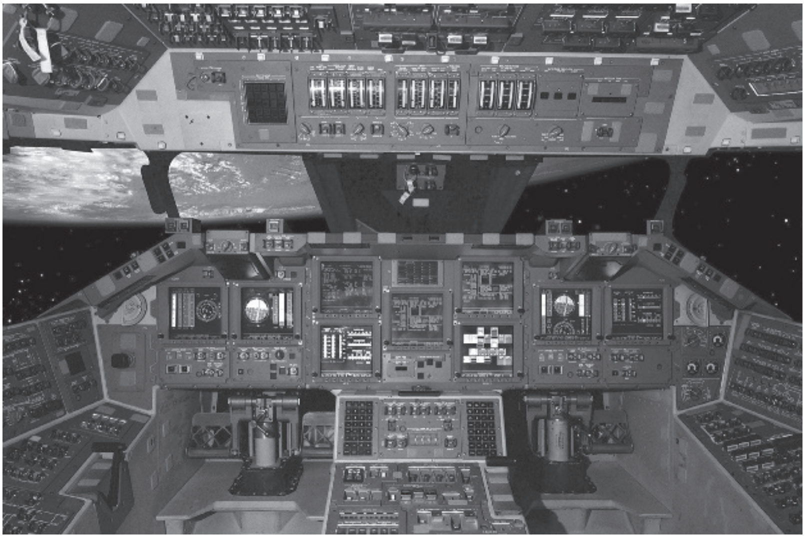


Photo courtesy of NASA.

- Monitoring performance on key value and business drivers.
- Increasing visibility into critical areas of business performance, allowing managers to assign and enforce accountability for performance.
- Providing an effective framework, allowing managers and employees to understand how their activities relate to operating and financial performance, and ultimately to the value of the company.
- Providing early detection of unfavorable events and trends, such as manufacturing problems, competitive threats, and product performance issues.
- Delivering critical information to managers and executives in effective displays or presentation formats that aid in identifying trends, problems, opportunities, and so on.
- Integrating into other management practices in the overall system of management processes that we will call the performance management framework (PMF).

- Identifying, monitoring, and mitigating risks.
- Providing information to managers to run the business.

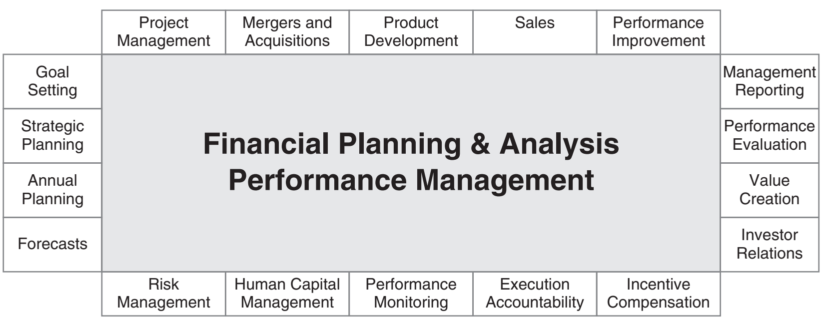
FP&A and PM must be integrated into other management processes as shown in Figure 1.2. Analysts and others involved in PM must play an active role in the management of the organization. They are not reporters or historians; they should help shape the outcome of the enterprise's efforts.

Understanding How Decisions Are Made

Since a substantial part of FP&A involves developing and providing information and analysis to managers, the analyst should develop an understanding of how the human mind receives and processes information as part of evaluating options and making decisions. The analyst bears a responsibility to develop and present findings in an objective manner that reduces bias and the tendency to reach less than optimum decisions.

A primary theme throughout this book is the important need to present and communicate business information effectively. This subject is the focus of Chapter 6, Communicating and Presenting Financial Information.

FIGURE 1.2 **FP&A and PM Must Be Integrated with Other Management Processes**



PREVIEW OF THE BOOK

The book has been written to address key areas of Financial Planning & Analysis and Performance Management from a practical point of view. While theory and technical aspects are included throughout the book, I have tried to incorporate real business applications from my 40-year career in business accounting and finance. The book contains five parts:

Part One: Fundamentals and Key FP&A Capabilities
Part Two: Business Performance Management
Part Three: Business Projections and Plans
Part Four: Planning and Analysis for Critical Business and Value Drivers
Part Five: Valuation and Capital Investment Decisions

Part One: Fundamentals and Key FP&A Capabilities

Part One builds a foundation for effective planning, analysis, and performance management. It includes a comprehensive review of financial statement analysis and presents analytical tools that can enhance the effectiveness of FP&A. For most finance professionals, Chapter 2 is primarily a review, so a quick perusal of this material may suffice.

In order to complement technical subject areas in the book, we cover best practices in developing financial models and in developing analytical capability. Finally, we address a significant weakness in many finance organizations: presenting and communicating business information.

Part One contains these chapters:

2. Fundamentals of Finance
3. Key Analytical Tools and Concepts
4. Developing Predictive and Analytical Models
5. Building Analytical Capability
6. Communicating and Presenting Financial Information

Part Two: Business Performance Management

In Part Two, we focus on subject matters traditionally associated with PM. After introducing keys to effective business performance management (BPM), we present the best practices in selecting key performance indicators (KPIs) and creating dashboards. In order to fully achieve the benefits of PM, it needs to be integrated with other key management processes. We introduce a challenge to PM leaders to focus on *what's important*, not just what is easy to measure. Since PM should also look outside the enterprise, benchmarking and competitive analysis are also presented.

Part Two consists of these chapters:

7. Business Performance Management
8. Dashboards and Key Performance Indicators
9. Institutionalizing Performance Management
10. Measuring and Driving What's Important: Innovation, Agility, and Human Capital
11. External View: Benchmarking Performance and Competitive Analysis

Part Three: Business Projections and Plans

In Part Three, we will cover best practices and techniques for planning, projecting, and forecasting future performance. In addition to traditional budgeting and operational planning, the implementation of rolling forecasts or business outlooks is also presented. Finally, we cover the unique challenges in projecting performance over an extended time horizon.

Part Three includes these chapters:

12. Business Projections and Plans: Introduction and Best Practices
13. Budgets, Operating Plans, and Forecasts
14. Long-Term Projections

Part Four: Planning and Analysis for Critical Business and Value Drivers

Part Four presents best practices and illustrations for planning, measurement, analysis, and improvement of key business and value drivers, in the following chapters:

15. Revenue and Gross Margins
16. Operating Expenses and Effectiveness
17. Capital Management and Cash Flow: Working Capital
18. Capital Management and Cash Flow: Long-Term Assets
19. Risk, Uncertainty, and the Cost of Capital

Part Five: Valuation and Capital Investment Decisions

Part Five presents planning and analysis of critical business decisions, including capital investment decisions, techniques for valuing a business, and analyzing value drivers. The section concludes with techniques to value a business, and the planning, analysis, and evaluation of mergers and acquisitions (M&A).

Part Five includes these chapters:

20. Capital Investment Decisions: Introduction and Key Concepts
21. Capital Investment Decisions: Advanced Topics
22. Business Valuation and Value Drivers
23. Analysis of Mergers and Acquisitions

Supplemental Information

Supplemental information includes a glossary, an index, and information on the CD or website available to purchasers of this book.

SUMMARY

Most senior financial and operating executives single out FP&A as one of the most important and, unfortunately, underperforming functions of the finance organization. Combining elements of classic FP&A with PM can unleash significant analytical horsepower that can assist the organization in executing its mission and achieving its objectives.

Before embarking on an initiative to improve FP&A and performance management, practitioners should develop a context based on the company's strategy and objectives, performance, and critical initiatives. This will ensure that the focus of efforts is directed to critical areas in the organization. Material found in Chapter 5, Building Analytical Capability, and Chapter 7, Business Performance Management, will be helpful to this cause.