

Balanced Scorecard **REPORT**

THE STRATEGY EXECUTION SOURCE

ON BALANCE

Transforming Operational Planning and Review into an Operating Strategy System

By Michael Contrada, Senior Vice President, Palladium Group, Inc.

Traditional operational planning and control refers to the management processes that focus on two fundamental activities: (1) implementing the strategic plan to produce short-term results; and (2) comparing performance against the plan and taking action to ensure that results, both strategic and operational, are achieved. Several recent BSR articles have elucidated the key components of operational planning and review processes that comprise three of the six stages of Kaplan and Norton’s Execution Premium management system: Align the Organization with the Strategy, Plan and Execute Operations, and Monitor and Learn.¹ Since these components constitute the newest elements in the evolving Balanced Scorecard-based management system, now is an opportune time to paint an integrated picture of what we call the “operating strategy system.”

What exactly do we mean by *operating strategy system*? While the term may be new to many, it has been used by operations-oriented consultants, performance management practitioners, and even some technology companies for some time. And there’s nothing new about the underlying concept. *Operations* refers to the day-to-day tasks of managers, supervisors, and workers. *Operating strategy* refers to the battery of executive decisions that focus on operational issues and tactics that, by definition, are the specific choices regarding resource allocation and the actions that are then taken to execute strategy and drive current- and next-period operations and results. However, the term “tactical (or operations) management,” while certainly an appropriate term for this domain of management, is not adequate. It does not capture the intent and requirement of the new Execution Premium management process—to make the linkage between strategy and operations a key part of the executive governing system, continuously aligning strategy and operational execution.

As discussed previously in *BSR*, the core management processes that make up the operating strategy system are:

1. Sales and operations planning
2. Corporate portfolio and initiative management
3. Driver-based planning and rolling forecasting

The first two processes define the performance targets, the associated initiatives to support them, and the resource allocation tradeoffs for the current planning period, which will vary depending on the business but usually cover the next one to two years. The third process translates these operational decisions into financial terms in the form of a financial plan, budget, or forecast, based on key operational drivers. Together, these three processes constitute the core building blocks of an operating strategy system, which must, of course, be integrated into the organization’s governance system. (See *Figure 1*, page 3.) Moreover, this

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operating strategy system, as we will see, represents much more than a traditional operational review process. As an integrated management approach that involves resource allocation, financial planning, and all the accompanying decisions that invariably require resource tradeoffs, executive leadership and executive decision making play critical roles in the operating strategy system. Let's discuss each process in turn.

Sales and Operations Planning

The fundamental job of business is getting product out the door and services delivered to customers—the “business as usual.” Sales and operations planning (S&OP) is the process of defining what will be sold (the demand) and what resources will be required to produce the products or services (the supply). This process of matching supply and demand for the current planning period (usually 12 to 24 months) requires aligning production plans with sales plans and, ultimately, both with strategic targets. S&OP is now widely used; the Luxfer case cited in note 1 is a prime example of a company that regularly—and rigorously—uses the process.

One of the most popular and well-known approaches to S&OP is put forth in the works of Thomas Wallace and Robert Stahl, authorities on sales, manufacturing, and supply chain planning and forecasting. In their book *Sales and Operations Planning: The Executive's Guide*, the authors emphasize the importance of executive decision making in both ensuring that current period sales and resource plans are aligned with strategy, and that resource plan tradeoffs are made.² They describe four core subprocesses that constitute S&OP:

1. Demand Planning. Forecasting sales, based on customers' actual level of demand for products and

services (as well as projections for new demand generated by marketing), and on the introduction of new products and services within the planning period.

2. Resource Planning. Establishing production, procurement, and capacity plans that support the sales plan and achieve inventory and backorder targets.

3. Master Scheduling. Planning detailed product mix and build schedules that balance supply and demand at the plant (or branch office) and individual resource level.

4. Executive S&OP. Setting high-level volume and rate targets (i.e., company aggregates), ensuring alignment with strategy, making resource tradeoffs, and adjusting and signing off on the resulting financial forecast relative to the annual financial plan (budget).

S&OP is a general term that refers to a planning process for aligning demand and capacity with high-level targets for volumes, prices, and margins—and ultimately for determining product and service mix. S&OP, as outlined here, is carried out in all organizations in one form or another. Some organizations may use Time-Driven Activity-Based Costing (TDABC), a sophisticated system developed by Robert Kaplan that relates costs to customer, product, and channel outcomes through activity analysis. (TDABC, a powerful means of planning resource capacity, eliminates the perceived complexity of Kaplan's original Activity-Based Costing approach.)³ Others may use spreadsheets, applying management rules of thumb. Whatever the system, what is critically important—beyond using good tools—is developing explicit assumptions for planning-period performance projections and recognizing that tradeoffs must be decided at the executive level, based on bottom-up analysis. The monthly

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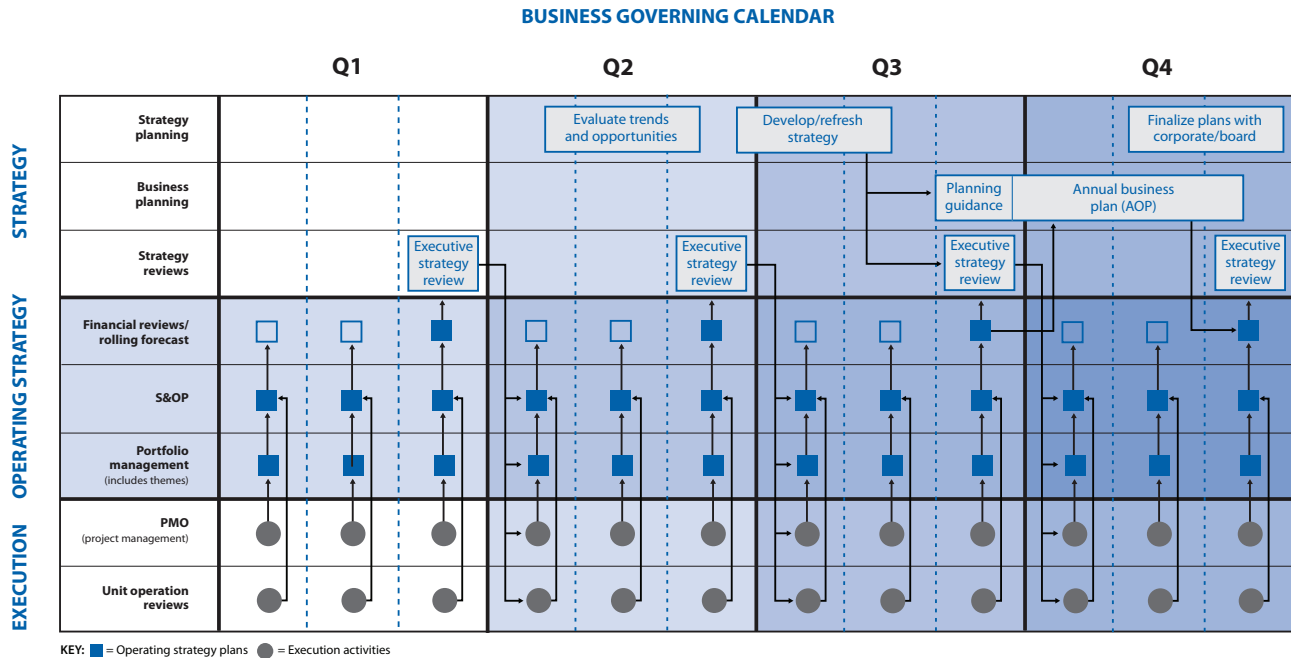
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Figure 1. How the Operating Strategy System Integrates Strategy and Operational Execution: A Best-Practice View



The simple traditional monthly operating review is being replaced by more robust decision-making approaches. (Full reviews/forecasts are prepared at the end of each quarter; some companies may also do a quick review each month, as represented by the unshaded boxes.)

executive S&OP review meeting, therefore, is a fundamental component of the operating strategy system.

Corporate Portfolio and Initiative Management

Corporate portfolio and initiative management, another critical component of the operating strategy system, is the process of managing discretionary spending and investment above and beyond the spending needed to deliver the current-period sales and production plan targets. Portfolio and initiative management involves a rigorous process of evaluating and prioritizing ideas, planning and approving their implementation, and instituting project and program management practices. Portfolios are gauged against a clear set of strategic objectives, measures, and targets; periodically reviewed as part of the strategy review process; and rebalanced as necessary to maintain targeted risk and performance levels.⁴

According to the Corporate Portfolio Management Association,

discretionary spending can run as high as 25% to 40% of expenses.⁵ Thus, how an organization manages such a big number is critically important to how well it optimizes business results and drives strategy execution.

The corporate portfolio encompasses all the types of discretionary spending available to a business. For the purposes of our discussion, we'll use three broad portfolio categories to classify discretionary spending: the *innovation* (or *strategic initiative*) portfolio, the *productivity* (or *process improvement*) portfolio, and the *infrastructure* (or the "keeping the lights on") portfolio.

The *innovation portfolio* refers to the strategic initiatives that are intended to transform the capabilities, positioning, and competitive advantage of a company. Generally multiyear and multiproject programs, they support key strategic priorities that represent activities above and beyond "business as usual" activities. *BSR* readers will recognize the process of managing strategic initiatives as Balanced

Scorecard strategic theme management, and the associated investments in these initiatives as StratEx—strategic expenditures, as distinct from CapEx and OpEx.⁶ (StratEx, incidentally, may represent about 10% of total discretionary spending.)

Beyond the strategic initiative or StratEx portfolio, however, there are other portfolio categories that must be managed to achieve optimum results. The *productivity portfolio* includes process improvement projects and programs. The focus of process improvement is incremental improvement—an ongoing goal of all processes, functions, departments, and units in a business. Lean Manufacturing, Six Sigma, and Total Quality Management are all established approaches for identifying and managing process change projects.

Finally, we have the *infrastructure portfolio*. This category encompasses the routine round of upgrades and maintenance that literally "keep the organization's lights on"—such as equipment upgrades, facilities expansion, IT

infrastructure improvement, routine training, and building maintenance and repair. The infrastructure portfolio may also include mandated changes, such as implementing compliance systems (e.g., Sarbanes-Oxley systems).

As part of the annual strategic planning process, top management sets the overall funding for these aggregate portfolios. The resulting portfolio mix reflects the organization's strategic priorities. A fast-growing company focused on emerging markets or a company pursuing a technological breakthrough will allocate more to the innovation portfolio in order to exploit such strategic opportunities. For more mature companies, the balance of investment will shift toward productivity and infrastructure.

This set of corporate portfolios requires executives' ongoing involvement and oversight. In the case of the innovation portfolio, BSC theme management of strategic initiatives creates a built-in, regular executive review process for strategic initiatives, as well as a mechanism for ongoing management by executive leaders. With productivity and infrastructure portfolios, however, leaders may conduct only an aggregate status review of them each month, and then rebalance the portfolios each quarter, based on current business conditions and the performance outlook. As with strategic initiatives, the active management of the portfolio projects and programs may be overseen by either functional leaders or dedicated program management offices (PMOs). Finally, as part of the executive S&OP process, the impact of strategic, productivity, and infrastructure initiatives within the current planning period must be identified and reflected in operating assumptions.

The key to successful portfolio management is defining a portfo-

lio management process and managing it deliberately to "optimize" investments. Anand Sanwal, in his book *Optimizing Corporate Portfolio Management* (see note 5), gives a full overview of how a rigorous portfolio and program management process can be adopted to manage the entire spectrum of discretionary spending—not just the innovation (strategic initiative) portfolio. As with S&OP, executives' active sponsorship of and engagement in portfolio management, along with their involvement in ongoing discretionary spending decisions, is a critical component of the operating strategy review process.

Driver-based Planning and Rolling Forecasting

The third major element of the operating strategy system is driver-based planning and rolling forecasting. Driver-based planning is an approach to financial planning that replaces the traditional budgeting process. It uses operational driver models—equations representing the mathematical relationships between key drivers (such as call volume, machine utilization, sales conversion ratios) and financial outcomes—to predict financial results. Fundamentally, driver-based planning along with rolling forecasting constitute the process of translating the S&OP and discretionary portfolio investments into a financial plan.⁷

Traditionally, creating a financial plan is an annual process that establishes the budget (sometimes called the annual operating plan, or AOP). However, given the continual round of updates executives must make to the S&OP and the discretionary investment portfolios (as suggested in the discussion above), it's clear that financial planning once a year is not adequate. Thus, more and more organizations have moved to rolling forecasting—if only partially, such as through monthly

sales updates or the quarterly reforecasting of annual results. True rolling forecasting provides a continuous performance outlook, at least five to six quarters out; its purpose is to provide a best estimate of expected future performance. Rolling forecasting is made feasible by adopting a driver-based approach to forecasting that frees the financial planning process of the detail associated with traditional budgeting by forecasting key operational "drivers."

Drivers, of course, are what S&OP, corporate portfolio management, driver-based financial plans, and rolling forecasting all have in common. They represent a shared set of business assumptions and are the key point of integration across these operating strategy processes. For example, the S&OP demand plan and the standard conversion and run rates in the production plan are sources of financial-plan drivers. Likewise, the run-rate improvements and savings assumed by the current slate of process improvement projects are sources for modifying financial-plan drivers. The impact of strategic initiatives in the planning period will also obviously affect financial-plan drivers. Because the relationships between inputs (e.g., inbound calls per month for a call center) and outputs (e.g., monthly capacity per agent improved by a training program or new technology) are transparent, all the assumptions driving a given expense or revenue forecast become much easier and more dynamic to plan and review. So once the StratEx, productivity, and infrastructure investments are factored into the S&OP assumptions, the financial plan or updated rolling forecast emerges almost automatically.

For financial planning, as with the S&OP and corporate portfolio management processes, executive leadership is essential when the core operating strategy compo-

nents are integrated and tradeoff decisions must be made. The interaction of these component parts represents the fundamental rhythm of the business and is the heartbeat of the governing system. Only those with the highest-level purview and authority (and accountability) are in the position to make such tradeoff decisions, often involving balancing competing priorities with scarce resources. When driver-based planning and rolling forecasting are done well, the final result is a fully aligned strategic, operating, and financial plan—and not just a once-a-year plan, but a continual one. Case studies already documented in *BSR* provide two examples of how companies have used driver-based planning and rolling forecasts—in combination with portfolio management, process improvement, and scorecards—to improve executive management decision-making and business results.⁸

From Operating Reviews to Operating Strategy System

One point deserves emphasis: executive-level involvement in an operating strategy system is not as simple as attending one operating review each month. While not all executives are required at all key decision-making meetings, the right leaders need to be there, and ideally, the CEO (or senior-most business unit leader) should participate too. Thus, in addition to a quarterly strategy review meeting, a monthly round of meetings among an executive team may include:

1. A *demand plan review* to sign off on sales forecast assumptions
2. An *S&OP review* to sign off on resource and action plan tradeoffs to reach desired planning period volumes, prices, and margins
3. A *strategic initiative review* to check status and rebalance, if necessary

4. A *productivity portfolio review* to check status and refocus, as required

5. A *rolling forecast review* to commit to next-period projected results

An operating strategy review system that requires as much executive input as described here has three key implications. First, the only way such a system can work is if the executive team can delegate the routine monitoring and interim decision making associated with the review process to appropriate cross-functional teams whose job it is to support these executive decision-making reviews. The model for this is the “theme teams” that oversee the strategic initiative programs defined by the strategy map (i.e., the innovation portfolio and StratEx). Second, the insights derived from these review meetings will help streamline and sharpen the focus of the quarterly strategy review meetings, making them shorter and more effective, since the executives will be coming to them fully armed with knowledge of the key operational drivers of performance. Finally, there is no “white space” or “bandwidth” left for additional scorecard reviews at levels lower than the entire business unless they are thoroughly aligned and integrated into these executive-level decision-making bodies in terms of key performance indicators (KPIs), targets, and project planning. There is simply no time for additional management process “overhead” if these cascaded scorecard reviews represent a separate set of meetings that do not feed the operating strategy system. In effect, this is what we mean by “operating strategy system”—explicitly building the governance process around key decision-making areas whereby operations and strategy become unified throughout the organization.

The Execution Premium model is a blueprint for the future of business management systems. Unlike the traditional notion of governance, in which strategy and operations are managed almost independently, with strategy being the province of senior executives, the new model recognizes the need to bring strategy into operational management—that executives must necessarily play an active, ongoing role in operations management. This discussion has attempted to synthesize some of the core aspects of the emerging operating strategy system, which explicitly builds the governing process around key decision-making areas related to linking strategy and operations. ■

1. See Robert S. Kaplan and David P. Norton, “Integrating Strategy Planning and Operational Execution: A Six-Stage System,” *BSR* May–June 2008 (Reprint #B0805A); and the authors’ new book, *The Execution Premium: Linking Strategy to Operations for Competitive Advantage* (Harvard Business Press, 2008). See also Randall H. Russell and Janice Koch, “Luxfer Gas Cylinders: Mastering the Strategy-Operations Linkage,” *BSR* May–June 2008 (Reprint #B0805B).

2. Thomas Wallace and Robert Stahl, *Sales and Operations Planning: The Executive’s Guide* (T. F. Wallace & Co., 2006).

3. See R.S. Kaplan, “Resource Capacity Planning in the Strategy Execution System,” *BSR* September–October 2008 (Reprint #B0809A).

4. Peter LaCasse, “Initiative Management: Putting Strategy into Action,” *BSR* November–December 2007 (Reprint #B0711B); and P. LaCasse, “Rebalance Your Initiative Portfolio to Manage Risk and Maximize Performance,” *BSR* September–October 2008 (Reprint #B0809D). See also R.S. Kaplan and Catherine Jackson, “Managing by Strategic Themes,” *BSR* September–October 2007 (Reprint #B0709A).

5. Cited by Anand Sanwal in “The Care and Feeding of Plus-Sized Portfolios,” *Business Finance*, September 2007. See also A. Sanwal, *Optimizing Corporate Portfolio Management* (Wiley, 2007).

6. For a discussion of StratEx, see D. P. Norton, “Linking Strategy and Planning to Budgets,” *BSR* May–June 2006 (Reprint #B0605A).

7. See a detailed discussion of this aspect of operational planning in D. P. Norton and Philip W. Peck, “Linking Operations to Strategy and Budgeting,” *BSR* September–October 2006 (Reprint #B0609A).

8. See two articles on Borealis: Thomas Boesen, “Creating Budget-less Organizations with the Balanced Scorecard,” *BSR* November–December 2000 (Reprint #B0011B); and “New Tools for a New Corporate Culture: The Budget-less Revolution,” an interview with T. Boesen, *BSR* January–February 2002 (Reprint #B0201C). Also see Lauren Keller Johnson, “Linking Strategic Planning and the Rolling Financial Forecast at Millipore,” *BSR* May–June 2007 (Reprint #B0705D).

Reprint #B0903A