Budget and Aggregate Metrics

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Alfred P. Sloan Professor of Management
The Delta Model - The Complete Framework

1. The Triangle - choosing the strategic position

2. The business Strategic Agenda - translating strategic positioning into execution

3. The Adaptive Processes - translating execution into concrete tasks

4. Aggregate Metric - the overall scorecard of business performance

5. Granular Metrics - de-averaging, explaining and exploiting variability

The Business Strategic Agenda
- Strategic thrusts
- Managerial accountability
- Business Processes
- Performance metrics

Innovation Strategic Agenda
- Strategic thrusts
- Managerial accountability
- Performance metrics

Customer Targeting Strategic Agenda
- Strategic thrusts
- Managerial accountability
- Performance metrics

Operational Effectiveness Strategic Agenda
- Strategic thrusts
- Managerial accountability
- Performance metrics

Aggregate Metrics
Measuring success in a broad comprehensive way

Granular Metrics & Feedback
Detecting, explaining and exploiting variability
<table>
<thead>
<tr>
<th>Performance Metrics for the Business Drivers of the Delta Model</th>
<th>Best Product</th>
<th>Total Customer Solutions</th>
<th>System Lock-In</th>
</tr>
</thead>
</table>
| **Operational Effectiveness (Cost Drivers)** | • Cost performance  
  - Unit cost  
  - Lifecycle cost  
  - Variable and total cost  
  • Cost drivers  
  • Quality performance  
  • Degree of differentiation | • Customer value chain  
  - Total cost  
  - Total revenue and profit  
  ▪ Customer economic drivers  
  ▪ Impact on customer profit due to our service vs. competitors | • Description of system infrastructure  
  ▪ Total system costs/revenues  
  ▪ Complementor’s investments and profits  
  ▪ Complementor costs of adhering to your standard  
  ▪ System performance drivers |
| **Customer Targeting (Profit Drivers)** | • Product market share  
  • Channel cost  
  • Product profit  
  - By product type  
  - By offer  
  - By channel  
  • Profit drivers | • Customer share  
  ▪ Customer retention  
  ▪ Our profitability by customer  
  - Individual and by segment  
  • Customer bonding  
  - Switching costs | • System market share  
  ▪ Our share of complementors  
  - % of investments tied to our proprietary standard  
  ▪ Our profit by complementor |
| **Innovation (Renewal Drivers)** | • Rate of product introduction  
  • Time to market  
  • Percent of sales from new products  
  • Cost of product development  
  • R&D as % of sales | • Relative involvement in customer value chain  
  ▪ Percentage of product development  
  - From joint development  
  - Customized  
  • Degree of product scope  
  - Current vs. potential bundling | • Switching costs for complementors and for customers  
  ▪ Rate of product development  
  ▪ Cost of competitors to imitate standard |
The Balanced Scorecard Provides A Framework To Translate A Strategy Into Actionable Terms

Balanced Scorecard

Customer Perspective
“How do we look to our customers?”

Financial Perspective
“How do we look to our shareholders?”

Business Processes
“What business processes are the value drivers?”

Organization Learning
“Are we able to sustain innovation, change & improvement”

Kaplan and Norton’s “Four Perspectives” As a “Balanced Scorecard”

**Vision and Strategy**

- **Financial**: “To achieve financially, how should we appear to our shareholders?”
- **Customer**: “To achieve our vision, how should we appear to our customers?”
- **Internal Business Process**: “To satisfy our shareholders and customers, what business processes must we excel at?”
- **Learning and Growth**: “To achieve our vision, how will we sustain our ability to change and improve?”

**Objectives**

- **Financial**: Objectives, Measures, Targets
- **Customer**: Objectives, Measures, Targets
- **Internal Business Process**: Objectives, Measures, Targets
- **Learning and Growth**: Objectives, Measures, Targets

- **Initiatives**

- **Vision and Strategy**

- **Balanced Scorecard**

- **Four Perspectives**

- **Kaplan and Norton**
Measures of Performance Related to the Financial Strategy

- **Capital market indices** oriented at representing an external assessment of the economic performance of the film in relation to key competitors, through a variety of popular and widely watched indicators such as: price earnings ratio (P/E), dividend yield (dividend-price ratio), earnings per share (EPS), market-to-book (M/B), and many others.

- **Profitability measures** being the most widely used: return on assets (ROA), return on equity (ROE), return on investments (ROI), and sales margin. It is important to observe the capability of the firm to earn a profit above its cost of capital. These measures can be contrasted with the firm’s competitors to judge the firm’s performance against its industry.

- **Risk** measured in terms of beta leverage (debt/equity) or bond rating, for example

- **Cost of capital** for both debt and equity, and other meaningful weighted average combinations of them

- **Growth** off assets, earnings, sales, investment opportunities, and whatever is considered relevant for the firm
THE BUDGET
Strategic funds are expense items required for the implementation of strategic action programs whose benefits are expected to be accrued in the long term, beyond the current budget period.
There are 3 major components of strategic funds:

1. Investment in tangible assets, such as new production capacity, new machinery and tools, new vehicles for distribution, new office space, new warehouse space, and new acquisitions.

2. Increases (or decreases) in working capital generated from strategic commitments, such as the impact of increases in inventories and receivables resulting from an increase in sales; the need to accumulate larger inventories to provide better services; increasing receivables resulting from a change in the policy of loans to customers, and so on.

3. Development expenses that are over and above the needs of existing business, such as advertising to introduce a new product or to reposition an existing one; R&D expenses of new products; major cost reduction programs for existing products; introductory discounts, sales promotion, and free samples to stimulate first purchases; development of management systems such as planning, control, and compensation; certain engineering studies, and so on.
### Splitting the Profit and Loss Statement of a Division in Terms of Operational and Strategic Expenses

A conventional statement of income typically separates expenses into operational and strategic categories. Strategic expenses, also known as development expenses, are not typically included in the operational component of the income statement.

<table>
<thead>
<tr>
<th></th>
<th>Conventional Statement</th>
<th>Operational Expenses</th>
<th>Strategic* Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales</strong></td>
<td>100</td>
<td>100</td>
<td>-</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable mfg. costs</td>
<td>30</td>
<td>30</td>
<td>-</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20</td>
<td>20</td>
<td>-</td>
</tr>
<tr>
<td>Other fixed mfg. costs</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>40</td>
<td>45</td>
<td>-</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing expenses</td>
<td>15</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Admin. expenses</td>
<td>10</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Research expenses</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td><strong>Division margin</strong></td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Operating margin</strong></td>
<td></td>
<td>35</td>
<td></td>
</tr>
<tr>
<td><strong>Total strategic expenses</strong></td>
<td></td>
<td></td>
<td>25</td>
</tr>
</tbody>
</table>

* Also called Development Expenses
### Strategic Funds Programming and Operational Budgets

— An Illustration

<table>
<thead>
<tr>
<th></th>
<th>History</th>
<th>Current Year</th>
<th>Projections</th>
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</thead>
<tbody>
<tr>
<td><strong>Total Market</strong></td>
<td>4,032</td>
<td>4,994</td>
<td>5,822</td>
</tr>
<tr>
<td><strong>Market Share (%)</strong></td>
<td>52</td>
<td>51</td>
<td>52</td>
</tr>
<tr>
<td><strong>Company Sales</strong></td>
<td>2,083</td>
<td>2,568</td>
<td>3,002</td>
</tr>
<tr>
<td>— Operating Cost of Goods Sold</td>
<td>1,789</td>
<td>2,138</td>
<td>2,499</td>
</tr>
<tr>
<td><strong>Gross Operating Margin</strong></td>
<td>294</td>
<td>430</td>
<td>503</td>
</tr>
<tr>
<td>— Operating SG&amp;A</td>
<td>62</td>
<td>103</td>
<td>110</td>
</tr>
<tr>
<td><strong>Operating Margin</strong></td>
<td>232</td>
<td>327</td>
<td>393</td>
</tr>
<tr>
<td>— Strategic Expenses</td>
<td>130</td>
<td>165</td>
<td>204</td>
</tr>
<tr>
<td><strong>SBU Margin</strong></td>
<td>102</td>
<td>162</td>
<td>189</td>
</tr>
<tr>
<td>— Taxes</td>
<td>5</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td><strong>SBU Net Income</strong></td>
<td>97</td>
<td>144</td>
<td>166</td>
</tr>
<tr>
<td>+ Depreciation</td>
<td>18</td>
<td>21</td>
<td>26</td>
</tr>
<tr>
<td>— Capital Investments</td>
<td>32</td>
<td>57</td>
<td>87</td>
</tr>
<tr>
<td>— Increases in Working Capital</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Contribution/Request of Funds to the Corporation</strong></td>
<td>83</td>
<td>108</td>
<td>105</td>
</tr>
</tbody>
</table>