SAP BusinessObjects™

**SAP Thought Leadership**
Enterprise Performance Management

# MANAGING FINANCIAL PERFORMANCE

## INTEGRATED, ENTERPRISE-WIDE PERFORMANCE AND RISK MANAGEMENT

High performers are quick to detect and respond to subtle changes in their markets, absorb external pressures without undue disruption, and consistently achieve superior results. Among these leading organizations is an increasing recognition of the value of using unified enterprise performance management solutions to measure, manage, and monitor their financial and nonfinancial performance.

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# EXECUTIVE SUMMARY

## BEST-PRACTICE PERFORMANCE MANAGEMENT

Implementing individual enterprise performance management (EPM) applications can bring great benefits to organizations, especially when replacing inefficient processes that relied on tools such as spreadsheets. But best-practice performance management, such as the Palladium Execution Premium Process™ set out by Doctors Robert Kaplan and David Norton in *The Execution Premium*, requires processes to run seamlessly across performance management applications.[1] Enterprise-wide integration enables the sharing of data, facilitates collaboration and communication, and improves decision making and organizational agility.

The core activities of enterprise performance management encompass budgeting, cost and profitability reporting, strategy management, financial reporting, and risk management. With sophisticated EPM solutions, companies can integrate, manage, and optimize enterprise-wide, risk-adjusted performance management.

SAP® BusinessObjects™ EPM solutions deliver best-practice performance and risk management functionality, with particular focus on delivering the important element of what-if scenario analysis. Integrated EPM solutions and processes enable stakeholders in roles throughout the organization to share data, communicate, and collaborate – and make better business decisions faster.

1. Robert S. Kaplan and David P. Norton, *The Execution Premium: Linking Strategy to Operations for Competitive Advantage* (Boston: Harvard Business Press, 2008).

# ANALYZING HIGH-PERFORMING COMPANIES

## RELIANCE ON UNIFIED EPM SOLUTIONS

The financial performance of commercial enterprises generally follows a bell-curve distribution. Relatively small numbers of low performers and high performers are found at either end, while the majority of companies, achieving average results, populate the middle. High performers are quick to detect and respond to subtle changes in their markets, absorb external pressures without undue disruption, and consistently achieve superior results. These leading organizations increasingly recognize the value of using unified EPM solutions to measure, manage, and monitor their financial and nonfinancial business performance.

Most organizations have many of the key components of enterprise performance management in place: they produce plans and budgets and routinely measure their progress toward their objectives. What is new to the discussion is the drive to bring key performance management methodologies together to deliver closed-loop performance management. This strategy is explored by Doctors Robert Kaplan and David Norton, whose six-stage Palladium Execution Premium Process™ is shown in Figure 1.[2] The best-practice performance management described by Kaplan and Norton requires performance management processes to run seamlessly across enterprise performance management applications. This level of integration makes data sharing possible across the enterprise, enabling business managers to collaborate and make better and quicker decisions that give the organization the agility it needs in today's increased uncertainty.

**Figure 1: The Palladium Execution Premium Process™**

Comprehensive enterprise performance management encompasses budgeting, cost and profitability reporting, strategy management, financial reporting, and risk management. Although finance organizations typically own and manage the core methodologies of EPM, its processes extend beyond the financial domain and unite financial and nonfinancial data. Key nonfinancial data includes budget line items and cost assignments in cost and profitability models, such as sales volumes, resource consumption rates, and capacity utilization.

EPM is concerned not just with historical reporting and variance analysis. Variance reports of historic financial performance do not add value, as they show only the financial outcome of some underlying issue. What is needed are insights into the nonfinancial drivers of revenues and costs, with enterprise-wide models bringing together data and cause-and-effect relationships. This way, managers can test assumptions and arrive at decisions that optimize future profitability.

2. Ibid.

To truly close the performance management loop and enable risk-adjusted planning, companies need to integrate risk management processes across the organization, from strategy development to operations. To achieve this, organizations must provide stakeholders in all roles with the tools and information they need to make risk-aware decisions.

Cost and profitability reporting makes comprehensive use of nonfinancial drivers, but many organizations have further work to do in this critical area of EPM. One of the key findings of the Financial Executives International (FEI) survey reported by global analysts Gartner Inc. in April 2010 was that "19.6% of financial managers view measuring product and customer profitability as the top constraint" – and twice as important as any other issue they face.[3] These findings confirm that cost and profitability reporting is typically based on high-level apportionments that fail to reflect the true cause-and-effect relationships between products and customers and the resources consumed in producing or serving them. Skewed results fail to reflect actual causality and can lead managers to make decisions that destroy value rather than create it. In practice, many managers are skeptical of cost and profitability reporting based on broad-brush apportionments and tend to ignore them. Many of the shortcomings of net cost and profitability reporting are due to the use of inappropriate modeling tools, such as spreadsheets, financial modules of transactional enterprise resource planning systems, or in-house solutions.

Douglas T. Hicks and other writers have consistently argued that the application of the cause-and-effect principles that underpin activity-based costing continues to be the only method of creating a valid economic model of an organization. A well-designed model is based upon empirical relationships between key business volume such as sales volumes and number of customers; consumption and productivity data; and expenses, revenues, and profits. As Hicks indicates, the result is a dynamic economic model of the enterprise, inside which changes to any data directly affect other data and financial outputs. Having managers validate and sign off on the modeling helps ensure credible results and gives users confidence in the models.[4]

3. John E. Van Decker, *2010 Gartner FEI Technology Study Research Collection* (April 28, 2010), 13.
4. Douglas T. Hicks, *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability* (Raleigh, North Carolina: Lulu, 2008).

# COST AND PROFITABILITY MODELING

## ASSESSING PERFORMANCE, IDENTIFYING UNDERLYING CAUSES

### Role of Cost and Profitability Models in Closed-Loop EPM

Cost and profitability models have an important role in any EPM deployment and bring two critical benefits.

#### Cost and Profitability Modeling for Insight

The basic goals of cost and profitability modeling are to produce accurate and credible reports of the costs and net profitability of products, customers, and channels and to promote a better understanding of underlying causes.

Kaplan and Norton advocate the use of cost and profitability reports for assessing enterprise performance: "Any time a company reviews its strategy, it should first understand the current economics of its existing strategy by examining activity-based costing reports that show the profit and loss of each product line, customer, market segment, channel, and region. Executives will then see where the existing strategy has succeeded and failed, and can formulate approaches to turning around loss operations and expanding the scope and scale of profitable operations."[5] It should also be noted that process costs, which are routinely calculated as part of cost and profitability reporting, can form a quarter of the measures needed to populate the internal processes perspective of a typical balanced scorecard.

Cost and profitability modeling helps managers understand both the underlying reasons for profitability and the actions needed to improve profitability. For example, to address customers with high costs to serve, companies can encourage the consolidation of numerous small orders into a single, more efficient order – saving money for both the company and the customer. Visibility into the precise causes of poor profitability supports faster, incisive decision making.

#### Cost and Profitability Modeling for Agility

Cost and profitability models link the cost and amount of resources being deployed (inputs), the amount of work being done (activities), and the outputs of the company, such as the number of each product being produced or sold and the number of customers. Many organizations extend their use of the models beyond reporting on historic cost and profitability data by using what-if functionality to test assumptions about the future. Modeling anticipated sales volumes and other inputs can reveal potential process and productivity improvements, enabling organizations to revise resource and capacity plans accordingly and expediting detailed budgeting activities.

**Operational viability** – Outputting a high-level profit and loss account effectively confirms that the company is operationally able to deliver the sales volume needed to achieve stakeholders' financial expectations within achievable productivity levels and current capacity constraints. This means that the strategy is effectively validated before detailed budgets are prepared, limiting the number of iterations needed to reconcile top-down financial objectives with bottom-up budgets.

**Capacity containment** – Having a detailed resource and capacity plan – in terms of the number of FTEs needed in each responsibility center every period – helps ensure that excess capacity is minimized across the organization. This will result in cost savings that drop straight to the bottom line and will speed up the budgeting process.

**Increased agility** – Being able to perform rapid what-if analyses to model the impact of factors, such as changes in demand or internal productivity levels, and to generate a new high-level profit and loss account will significantly reduce the time needed to produce a reforecast. In researching best practices in planning, budgeting, and reforecasting, Aberdeen Group analysts found that best-in-class companies were finding more pressure to respond to the turbulent economy with increased agility. They were also significantly more likely to apply what-if scenarios during the reforecasting process. The authors commented that these methodologies help shift the focus away from the rear-view mirror in order to concentrate on the road ahead. They emphasized that a more dynamic forecast is now a much more critical component of the process.[6]

5. Robert S. Kaplan and David P. Norton, "Mastering the Management System," *Harvard Business Review* (January 2008): 76.
6. *Financial Planning, Budgeting and Forecasting: Managing in Difficult Economic Times*, Aberdeen Group (February 2009).

# WHAT-IF MODELING

## BENEFITS OF FREQUENT REFORECASTING

Figure 2 shows the type of what-if modeling that can be done for the operating expenses of ongoing businesses when using the SAP BusinessObjects Profitability and Cost Management application. It also shows how the outputs can be shared with the SAP BusinessObjects Planning and Consolidation application to speed up planning, budgeting, and reforecasting processes and to help enable a more agile enterprise.

More frequent reforecasts bring significant benefits. At a time when cost management is critical, more frequent reforecasts force managers to review their resource requirements and keep them better aligned with demand. What's more, a what-if model inevitably includes important business drivers, such as market size, market share, and productivity levels, which may previously have been dissipated across the organization on a plethora of spreadsheets. Because there is now visibility of the underlying assumptions involved in producing the budget, managers have less opportunity to submit a budget that can be easily achieved in order to secure their bonuses. Over time, everyone should be working toward optimal capacity management – smoothing the peaks and troughs to close the gap between resource demand and supply and to improve organizational efficiency.

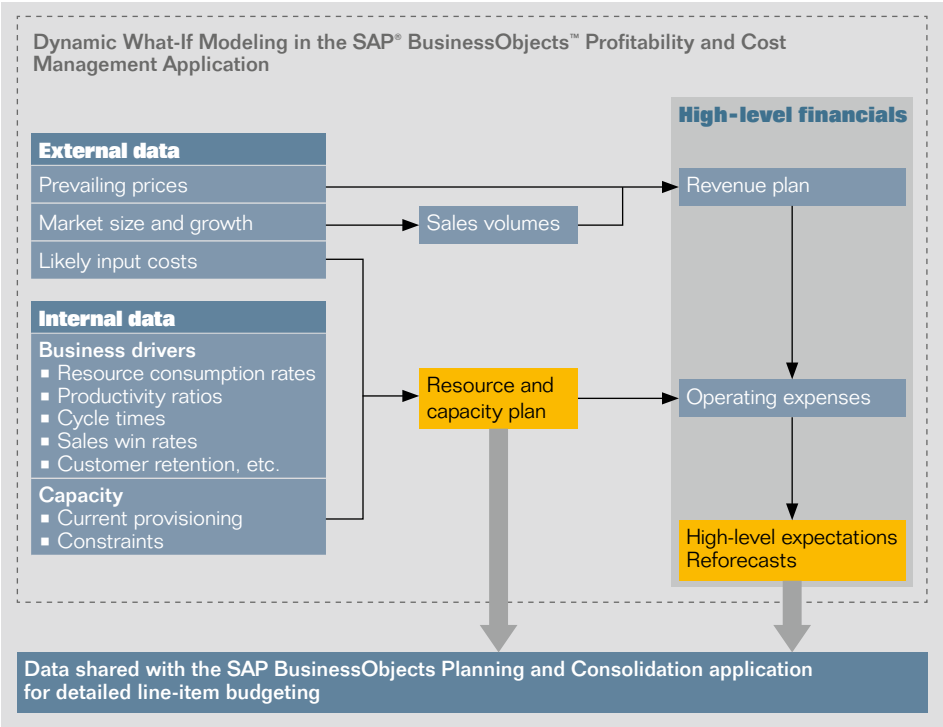


**Figure 2: Dynamic What-If Modeling in Closed-Loop Performance Management**

The other main benefit of more frequent reforecasting is better visibility into future performance. If all the drivers of financial performance, including productivity levels, sales win rates, market share, and market growth, are updated on a regular basis, the organization is better able to sense and respond to issues. Rather than stumble upon an issue in a future period, by which time it may become a major problem, the organization gives itself time to assess the likely impact of changes in a leading indicator and respond. It gains agility – and critical time to act and defend the bottom line.

# ENABLING INTEGRATED RISK-ADJUSTED PLANNING

## ENTERPRISE-WIDE PERFORMANCE AND RISK MANAGEMENT

To truly close the performance management loop and enable risk-adjusted planning, companies need to integrate risk management processes across the organization, from strategy development to operations. To achieve this, organizations must provide stakeholders in all roles with the tools and information they need to make risk-aware decisions.

But many organizations do not formally integrate risk management into their planning and budgeting activities. Planners thus make "finger in the air" assessments, skewing cost and revenue projections in an attempt to account for risks that are not well-defined, understood, or quantified. With such a disconnected and unregimented approach, risks are not made explicit and transparent and cannot properly be tracked, modified, or mitigated.

### The Role of Risk Management in Closed-Loop EPM

To enable risk-adjusted planning, companies must institute an integrated framework to continuously manage risk. Companies need to understand their appetite for risk and have a strategic plan. Risks specific to the organization must be identified and assessed, with assignments made for probabilities of occurrence, projected impacts on revenues and expenses, and so on. Response plans to specific risks must be created and implemented. For example, the risk of rising costs could be offset with a plan for sourcing through multiple suppliers or by increasing the amount of inventory or raw materials kept on hand. Finally, the identified

### Jobcentre Plus

Part of the United Kingdom's Department for Work and Pensions (DWP), Jobcentre Plus provides support and benefits for the unemployed.[7] It has 70,000 employees in offices across the United Kingdom and an operating budget of £3.3 billion (US$5.4 billion). Faced with a government mandate to improve productivity and reduce costs, the agency implemented what it has labeled "integrated planning and performance management" – closed-loop performance management based on three key elements:

- **Performance management** – A balanced scorecard to present strategically important information to senior managers
- **Understanding of the cost base** – Cost modeling to provide accurate costs of different services across multiple dimensions and to enable rapid assessment of the impact that different levels of demand and different assumptions have on future resource and capacity needs
- **Continuous planning** – Provision of accurate and reliable information so that managers can discuss and decide rather than simply review and approve as they did in the past

Jobcentre Plus used the SAP® BusinessObjects™ Profitability and Cost Management application to achieve these goals. Using the application has given the agency a better understanding of end-to-end process costs and has allowed it to benchmark unit costs across the organization in order to identify best practices. These insights have given managers the information they need to manage the actual drivers of cost rather than the cost itself. As a result, the agency has exceeded all of its improvement targets, with an efficiency savings of 5.6%, which is equivalent to an annual savings of £1.2 billion (US$1.9 billion).

But the use of the application goes beyond calculating unit costs. By using the what-if functionality, the agency can rapidly assess the impact of likely demand in the context of changing assumptions and generate resource plans and high-level financials across a three-year time horizon. This dynamic modeling has resulted in greater accuracy in both forecasts and budgets. It also made it easier and quicker for the agency to justify a request for additional funding to cope with the increased number of unemployed that resulted from the recent global economic downturn.

At the same time, the ability to run scenarios means that the impact of process improvement initiatives can be validated before they are implemented. These insights minimize the risk of failure and give managers the confidence they need to make incisive decisions.

7. *Best Practices: Performance Management at DWP's Jobcentre Plus: A ProveIT Case Study*, IDC Government Insights (July 2009)..

## Zions Bancorporation

"We are a holding company with over 500 bank branches in 10 western U.S. states," says Matthew Despain, business analyst for Corporate Finance at Zions Bancorporation, "and we are a longtime user of SAP BusinessObjects software." As an example, for its business operations Zions uses the SAP® BusinessObjects™ Planning and Consolidation application for planning and budgeting and the SAP BusinessObjects Profitability and Cost Management application, combined with SAP BusinessObjects Xcelsius® Enterprise software,* for modeling costs.

Zions uses its performance management solutions to feed costs, together with interest spreads calculated in the bank's funds-transfer pricing solution and loan loss provisions, into a "profitability mart" – and then to calculate net profit at the individual account level. "Knowing how different products and different types of customers create value for the bank is critically important to many business decisions that executives and managers have to make," says Despain. This information helps them determine, for example, where to spend marketing dollars and how to price individual loans.

But the bank will get much more from its implementation of SAP BusinessObjects solutions than simple best-of-breed deployments and the reality of closed-loop performance management. For example, the software can take trended volumes and activity unit rates from the planning and consolidation application and combine them with data on interest spreads and fee income from its shareholder value model, which summarizes the data in the profitability mart. In the future, Zions plans to use this functionality to autopopulate many of the important line items in its budget. This means that business managers will no longer have to forecast expenses themselves and can simply review and amend the figures generated for them.

It also means that budgets will be quicker to produce and more accurate. In addition, this budgeting functionality will allow quarterly rolling reforecasting, rather than the traditional annual budget and semi-annual review, enabling the bank to keep resources and capacity more tightly aligned with demand.

* SAP BusinessObjects Xcelsius Enterprise is now called SAP BusinessObjects Dashboards software

risks, along with the company's responses, must be continuously monitored and reassessed.

What is needed are sophisticated, enterprise-wide solutions that enable organizations to integrate risk management information and processes. The SAP BusinessObjects Risk Management application and other solutions in the SAP BusinessObjects portfolio help companies identify, track, and mitigate risk across the organization.

Through its integration with SAP BusinessObjects Planning and Consolidation, SAP BusinessObjects Risk Management makes risks and associated costs visible in the budgeting process. Planners and others involved in the budgeting process can monitor and track possibilities and likelihoods, change risk parameters, and see potential results of changes. Sophisticated functionality gives stakeholders throughout the organization the tools and information they need to make better-informed, risk-aware decisions. With risk-adjusted planning, your organization can:

- Create more accurate budgets and projections
- Make better business decisions with a holistic perspective that includes operations, financials, and other factors and drivers
- Build a culture that is more aware of both the opportunities and the pitfalls of risk

# CLOSING THE LOOP

## BENEFITS OF SHARING DATA BETWEEN APPLICATIONS

### Benefits of Closed-Loop Performance Management

Closing the loop with integrated enterprise performance and risk management solutions and processes enables stakeholders to share data, communicate, and collaborate. With SAP BusinessObjects EPM solutions, companies can deliver best-practice, risk-adjusted performance management functionality to employees throughout the organization and realize a range of benefits:

- **Agility** – Accelerate variance and risk detection and scenario assessment for faster, more incisive responses that enable first-mover competitive advantage
- **Insight** – Gain a deeper understanding of the underlying drivers of cost, profitability, and risks to recognize and address variances, build more accurate budgets, and mitigate enterprise risk
- **Alignment** – Align vertical and horizontal strategies, operational capacity across responsibility centers, and shared services resources with frontline needs for a more effective and efficient organization
- **Visibility** – Improve visibility into future profitability through rapid and more frequent reforecasts that accurately reflect real operational needs and minimize the likelihood of variances

The only large-scale study to assess the impact of corporate performance management (CPM) on actual results was carried out by the Aberdeen Group, which tracked results from 350 respondents.[8] They found that more than 70% of companies that adopted some sort of CPM program enjoyed improvements in key performance metrics. Moreover, the results were consistent across industry segments and company size, with the average improvement being a 5% gain in return on assets (ROA) and a 4.9% gain in gross margin. However they found that the approach to CPM that best-in-class companies take is significantly different from that of their peers, and they achieve better performance as a result.

> What is needed are insights into the nonfinancial drivers of revenues and costs, with enterprise-wide models bringing together data and cause-and-effect relationships. This way, managers can test assumptions and arrive at decisions that optimize future profitability.

Best-in-class companies approach CPM analysis with a far greater focus than their peers on the following:

- Balanced scorecard versus individual metrics
- Continuous improvement and closed-loop decision processes
- Cross-functional root cause analysis
- Forward-looking business data analysis and simulation

According to this Aberdeen Group study, companies that deployed these best-in-class CPM processes and technologies – 12% of the sample – significantly outperformed their competition in both ROA and gross margin. Specifically, they outperformed competitors who met the industry norm by 5.4% on ROA and by 4.8% in gross margin. And they outperformed competitors who operated below the industry norm by 8.8% in ROA and by 7.8% in gross margin.

### Smoothing the Path with SAP BusinessObjects Software

Most organizations already have the fundamentals of integrated performance management in place. They have a budgeting process; they monitor key performance metrics; and they do some form of cost accounting. In many instances the individual processes may not be supported by best-of-breed software, making them laborious to manage and maintain. But even where best-of-breed applications are deployed, they are rarely integrated to allow the rapid and efficient exchange of data required to provide the agility needed today.

SAP offers a wide range of software and services that enable integrated performance management. Solutions from SAP can enable a smooth, flexible migration starting with immediate challenges but working toward the deployment of SAP BusinessObjects EPM solutions that cover the full lifecycle of integrated performance management, putting you decisively in control and enabling the agility you need to manage effectively in times of uncertainty. Many SAP customers are already using two or more EPM solutions and are exchanging

8. *The Corporate Performance Management Benchmark Report: Improving Corporate Decision Making Through Proactive Analysis*, Aberdeen Group, www.aberdeen.com/summary/report/benchmark/perfmgmt_093004b.asp (September 2004).

data between them as they progress toward completing their objective of closed-loop integrated performance management.

SAP BusinessObjects software provides comprehensive support for the implementation of integrated performance management. The EPM solutions, which have been directly mapped to the Palladium Execution Premium Process™ (XPP), help integrate enterprise data and processes, delivering insight to help you align business strategies better and achieve financial excellence:

- **SAP BusinessObjects Planning and Consolidation application** – Increase accuracy in planning at every level, while reducing budget cycles and associated costs
- **SAP BusinessObjects Profitability and Cost Management application** – Enable business users to identify the causes of underperformance, test the impact of changes, and take action to reduce costs and optimize profitability across dimensions such as product, customer, and channel
- **SAP BusinessObjects Risk Management application** – Drive risk-adjusted performance management and planning; maximize return on capital by facilitating agreement on top risks, creating resolution strategies, and building proactive monitoring into existing business processes
- **SAP BusinessObjects Strategy Management application** – Allow users to set goals, map strategies, and monitor and manage performance from high-level objectives down to operational metrics
- **SAP BusinessObjects Financial Information Management application** – Enable financial professionals to manage the process of accessing, mapping, loading, and exchanging information from source systems to other EPM solutions

The core activities of enterprise performance management encompass budgeting, cost and profitability reporting, strategy management, financial reporting, and risk management. With sophisticated EPM solutions, companies can integrate, manage, and optimize enterprise-wide, risk-adjusted performance management.

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