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How Finance is Quietly Emerging as a Key to Business Transformation

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CATALYST
STRATEGIST
STEWARD
OPERATOR

FINANCE MASTERS:
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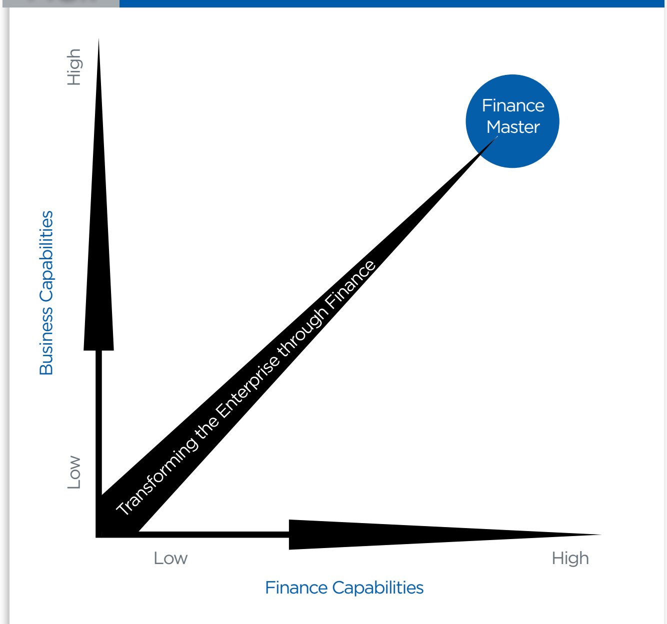
From distant mining in South Africa and commodity production in Asia to sales and service networks in North America, the business operations of some of the world's largest and most sophisticated industrial enterprises are experiencing a quiet revolution. It is being led by Finance.

Over the last five years, Deloitte Services LP has benchmarked the global strategies, financial and operational capabilities, and business performance of more than 1,100 companies around the globe (see "Global Survey" sidebar on page 42). We discovered that many companies are struggling despite large-scale investments in performance improvement.[1] Our research revealed that companies face three primary barriers to improving business performance:

- ***Insufficient alignment between strategic and operational decision making and operating model*** (for example, conflicting business objectives), and lack of talent to support the model
- ***Lack of up-to-date information for strategic and operational purposes*** (for example, quality of information available around growth, cost and profitability by product, customer, geography and channel)
- ***Inadequate process and data standards*** (for example, non-uniform standards on products, customer information and transaction processes)

FIG.1 Transforming the Enterprise through Finance



These barriers are pervasive and the cumulative impact can be troublesome, typically resulting in business performance that is mediocre at best. For example, our analysis of the 100 largest manufacturers listed on United States stock exchanges showed that 32 percent had a negative average economic margin over a five-year period.[2] What is common to these barriers is the potential for Finance to change the game – indeed Finance emerges in our analysis as something of a common denominator for companies that have overcome these impediments. In most of the companies studied, there is a notable lack of the financial management competencies necessary to overcome these barriers and drive business performance. Given the realities of modern multinational businesses, this is not surprising: with their complex networks of production facilities and distribution centers, customer and suppliers, and resulting flows of products, services, finance and information, global companies have a hard enough time just tracking financial performance. To most, *mastering* finance may seem like a pipe dream, but change is afoot in many of the world's forward-thinking companies where Finance, while ubiquitous as a corporate function, has taken on a far greater role.

In some of the companies we studied, financial management is evolving from an uninspiring, albeit necessary, function of doing business to one of the most promising levers of business transformation. In fact, without support from the Finance function in improving strategy and operations, companies face an uphill and often losing battle in transforming their business. Findings from our research underscore the importance of Finance. Among the companies analyzed to date, the group we call "finance masters"—companies with the strongest finance capabilities in place to support business transformation—are leading the pack with superior business performance (see figure 1). The research not only links the transformation of the Finance function and the business to performance, it also shows how finance masters differentiate themselves from the competition.[3]

If luxury automaker Porsche AG has enjoyed financial success, its adept use of financial management demonstrates why. For example, the company centralized treasury functions for its many country operations, allowing Porsche's corporate finance function to manage and reduce currency risk exposure for the global company. It used currency hedging to guard against declines in the U.S. dollar versus the euro. Similarly, Porsche used financial instruments in its recent purchase of stock in Volkswagen AG to reduce the risk of share price increases. More than 50 percent of Porsche's pre-tax earnings of €5.9 billion in the latest fiscal year came from returns on financial hedging and financial investments.[4]

THE MANY FACES OF FINANCE

At the heart of this new, expanded role of Finance is the concept of *finance transformation*, an umbrella concept that focuses on improving performance, stewardship and control of the company by enabling chief financial officers and their Finance organizations to have greater impact on strategy formulation and execution across the enterprise. Finance transformation is rarely a panacea, but it does have the potential to provide the underpinnings of effective enterprise transformation and help put the company on the path to sustainable, profitable growth.

However, to be truly worthy of the term, finance transformation must extend well beyond the walls of the Finance function. Indeed, our research shows that it is the combination of core finance capabilities and business capabilities that drives performance (see figure 1).

> Not only did Apple hedge the supply risk for a potentially hot product by locking up a significant part of global flash memory capacity, it also constrained competitors from ramping up production of competing products.

Finance capabilities: In this category, we include the role of Finance as a *steward*: ensuring companywide compliance with financial reporting and control requirements, managing risk, and providing high-quality business and operational information across the enterprise. We also include the role of Finance as an *operator*: defining and adapting the operating model to balance efficiency and service levels in financial processes, and ensuring the availability of high-skill financial management talent.

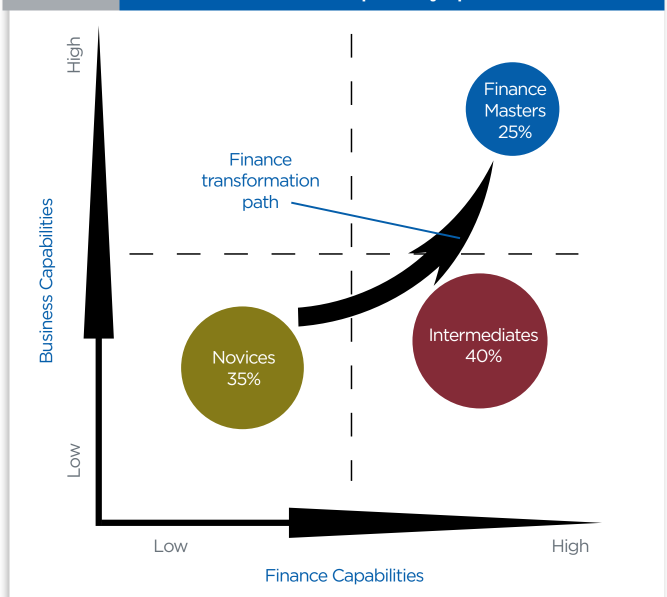
Business capabilities: Here we include the roles of Finance as a *strategist*: supporting business strategy development through robust decision-making processes and performance management, and the role of Finance as a *catalyst*: partnering with business executives to change organizational behavior and drive disciplined execution of strategic choices across the enterprise, including marketing, sales, service, supply chain and innovation.

We analyzed and rated the companies participating in the research along different dimensions of finance capability maturity (see "Global Survey" sidebar on page 42). Our research suggests that Finance needs to go beyond the core finance capabilities of *steward* and *operator* to leverage business capabilities as *strategist* and *catalyst*. In fact, the only strong link between finance capabilities and business performance in our analysis is through the role of Finance as a strategist and catalyst.

Many of the companies we studied find the Finance *steward* and *operator* roles challenging. Others have shown great strides in building core finance capabilities around stewardship because these are mandated by governments and financial markets – regulatory reporting (GAAP, IFRS, Sarbanes-Oxley), environmental reporting, tax compliance and credit management.

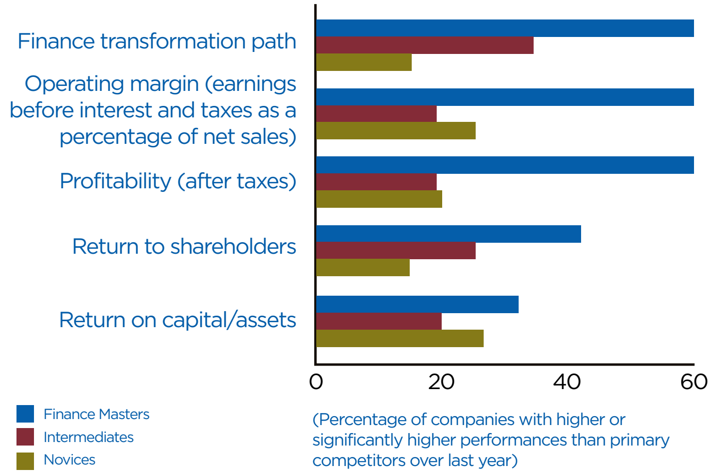
However, the vast majority of studied companies struggle in using finance capabilities to develop and execute business strategy. Indeed, the business capabilities of Finance as a strategist and catalyst are among the weakest areas of financial management today. Financial planning and analysis remain underdeveloped capabilities; even in more operational areas, such as leveraging investments in plant and equipment assets, a significant number of companies struggle to build finance capabilities. And while companies' valuations increasingly consist of intangibles like brand, goodwill and intellectual property, few companies excel in evaluating and leveraging those assets.[5]

FIG.2 Defining Finance Masters: The finance and business capability quadrant



Among the companies benchmarked to date, about 35 percent—the "novices"—reported that their Finance functions have limited capabilities as stewards and operators, as well as limited business capabilities as strategists and catalysts (see figure 2). Another 40 percent of companies—the "intermediates"—have made great inroads in building their core finance capabilities, but they have yet to effectively build their business capabilities as strategists and catalysts. Finally, about 25 percent of companies—the "finance masters"—have not only invested in strong core finance capabilities, they have gone further by building much better business capabilities to support business improvement and transformation. While they are by no means perfect, they have charted a finance

FIG.3 Finance Masters outperform

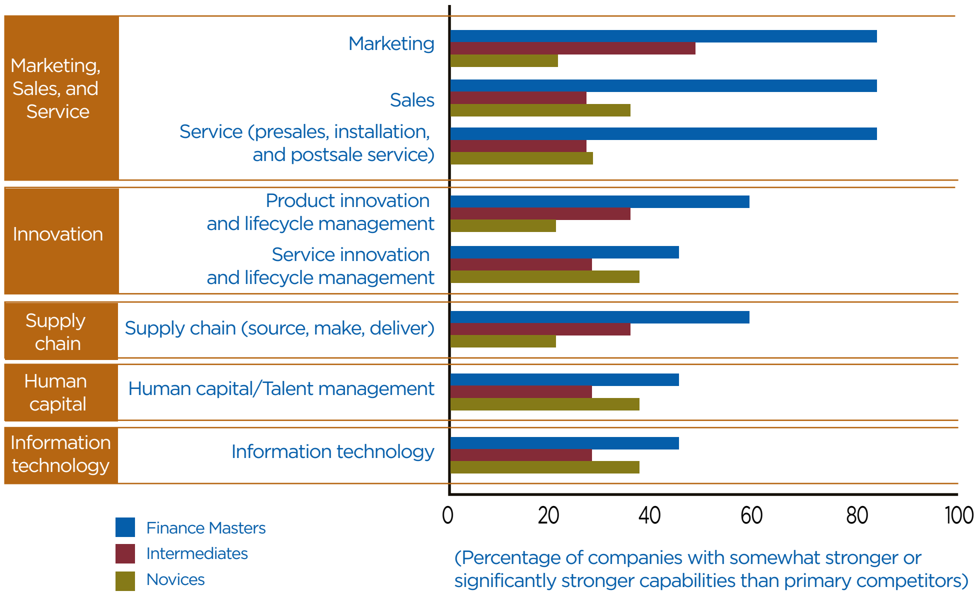


transformation course that sets them apart from their peers with significantly higher performance in terms of profitability, returns on assets and shareholder value (see figure 3).[6]

Our analysis also reveals a key aspect of finance transformation: *The path to finance mastery is built on finance stewardship and operations.* Put simply, there is no company yet participating in our research that has been able to master strategist and catalyst capabilities without a foundation in strong stewardship and operator capabilities (see figure 2). What is more, the finance masters as defined in this study have, in many cases, stronger stewardship and operator capabilities than the intermediates. Thus, mastering finance as strategists and catalysts does not mean that stewardship and operator capabilities are neglected. In fact, our research indicates that stewardship and operator capabilities provide a crucial underpinning for the path to effective business transformation. Companies across a range of industries and geographies have started the journey with impressive results in a number of areas.

Owens-Illinois (O-I), the world's largest manufacturer of glass containers, is one firm that is exploring how to leverage its Finance function. Its "One O-I" effort involves transforming the company's Finance function into a modern, global, world-class Finance organization. Initially, O-I's efforts were focused on Sarbanes-Oxley compliance. The second stage, supported by insights gleaned from the Sarbanes-Oxley compliance program, focused on developing the policies, standards and operating and competency models of the new globally integrated Finance organization. The third stage—and arguably the most important—focuses on how to use Finance to help transform the business. A key aspect is the need to align operational strategies and investments with overall drivers of business performance, such as revenue growth, operating margin and asset efficiency, and broadening the financial goals of the company beyond a previously single-minded focus on earnings per share toward more urgent financial measures such as free cash flow. While the results rarely materialize overnight, O-I's Finance function is increasingly being perceived as a proactive leader in the company's quest for change.

FIG.4 Business capabilities of Finance Masters stronger



ACROSS THE BOARD

Apart from encompassing key roles of corporate strategy and execution, finance transformation must have an important role across operational business departments such as marketing, sales and service; supply chain; research and development (R&D); information technology (IT); and human resources. In just about all these areas, finance masters have moved ahead of their competitors, according to our research (Figure 4). While the challenges of Finance making an impact on business are great, the opportunities are typically greater, as illustrated by the experiences of the following companies as they are finding their own finance transformation paths.

Marketing, sales and service

In the case of the Chinese operations of chemical giant BASF, Finance helped create a foundation of metrics around the notion of "customer lifetime value" and develop a sales and service approach focused on serving better the most valuable customers. With a deep understanding of the costs and benefits of winning and serving customers, the Finance function could link compensation to key financial metrics such as cash flow and days sales outstanding (DSO; a measure of how fast companies are turning sales into cash). The result was higher revenue growth as the sales force systematically focused on higher-opportunity customers. Better service led to better customer retention, and DSO and cash flows improved as BASF China's customers became more loyal with better payment records.[7]

Similarly, for Rolls-Royce, Finance plays a critical role in developing and implementing service strategies. More than 53 percent of Rolls-Royce's revenues come from services. Like many of its competitors, the jet engine and power generation equipment maker is increasingly focused on selling "power by the hour" – letting the customer pay for the hours engines are running through multi-year contracts.[8] As Rolls-Royce and others in the industry are increasingly adopting this business model, they need to concurrently develop financial management processes so that effective financial planning can be undertaken, profits and costs managed, and commercial decisions made more rapidly and consistently across the service business. This means that companies must integrate financing, products, field services, parts, information and other essential ingredients in one package and price it according to the usage, risks and returns expected over a number of years.

Supply chain

Apple showed how going beyond merely avoiding supply risk to exploiting it through strategic risk management can provide the underpinning for new strategies and better investments.[9] When Apple launched the iPod Nano MP3 player, it secured the supply of flash memory through a forward-buying contract worth more than US$1 billion to lock in adequate flash memory capacity. Not only did it hedge the supply risk for a potentially hot product by locking up a significant part of global flash memory capacity, it also constrained competitors from ramping up production of competing products.[10]

Research and development

Despite being recognized as an innovation leader in the industry, Hershey—the iconic maker of Hershey's chocolates and other branded products—recognized that too much time and resources were spent by R&D and marketing teams to evaluate costs and opportunities of new product ideas early in the innovation life cycle.[11] Hershey's Finance team was already heavily involved in new product development stage-gate processes, but not enough. To improve innovation speed and efficiency, Hershey's Finance organization helped develop analytical tools that marketing and R&D could use to evaluate new product concepts. Key aspects of this work included developing new criteria for evaluating products, setting goals, developing analytical tools, and training brand teams in different aspects of financial analysis.

Human capital

Harmony Gold is the world's fifth-largest producer of gold with mining operations in some of the most inaccessible areas of the world: It has been an astute user of Finance in driving decision-making around strategic mining investments and operations (such as mine closures and shaft mining prioritizations). Its prowess in finance, however, has come to a significant test as the company is trying to survive and manage a health and human capital crisis of gigantic proportions. An estimated 30 percent of its labor force was infected by HIV/AIDS by 2005; its projected annual employee health care would cost more than US$30 million, including medical cost, paid sick leave, lost productivity, funeral leave, training and replacement, disability processing, and cost of treatment programs.[12] In addition, the associated risk premium to the company's stock had a significant negative effect on total enterprise valuation by capital markets. [13]

The situation may have seemed hopeless, but Harmony Gold is applying the tools of financial management to the crisis. Detailed analysis of mining operations, worker scheduling and treatment processes is giving the company insight into the financial cost and opportunity of improved treatment programs and worker participation in those programs. Analysis of drug sourcing is providing a view to help effectively manage the global drug sourcing cost and financial

THE GLOBAL SURVEY ON TRANSFORMING THE ENTERPRISE THROUGH FINANCE: AN INVITATION TO PARTICIPATE

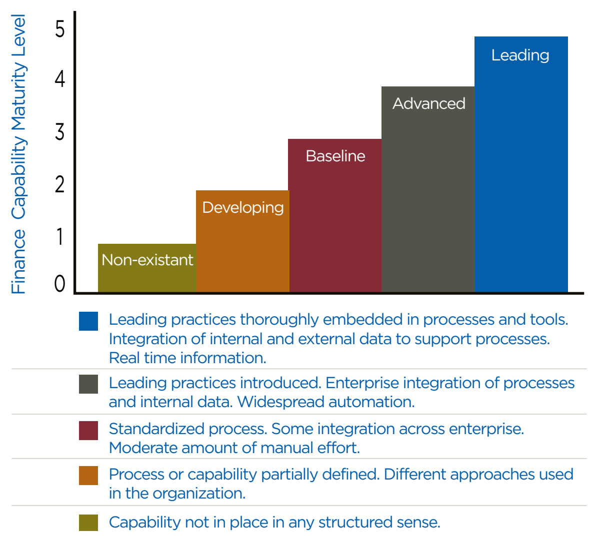
TO DEVELOP A DEEPER PERSPECTIVE on how companies can build and leverage financial management capabilities to help improve and even transform business strategy and operations and drive performance, we initiated the Deloitte Global Survey on Transforming the Enterprise through Finance, an ongoing, multi-year benchmark study specifically focused on how companies are transforming their enterprises through Finance.

So far more than 70 companies have participated around the world; about one-third have corporate headquarters in the Americas, 44 percent in Asia Pacific, and about one-quarter in Europe, Middle East, and Africa. Of the respondents, 75 percent have corporate revenues higher than US$1 billion and 16 percent have corporate revenues higher than US$25 billion.

Industries represented include aerospace and defense, automotive and commercial vehicles, consumer products, industrial products and services, process, chemicals, high technology and telecom equipment, life sciences, and other industries. For those readers working in public sector organizations, a parallel global study focused on government organizations is under way.[14]

The finance capability maturity model scale used to rate companies in this study is described in figure 5.

FIG.5 Scale for finance capability maturity level



risks, such as rising prices and currency movements. By applying the principles of financial portfolio optimization, the company is taking a holistic approach to resolving the HIV crisis. This includes creating portfolios of possible HIV treatment programs—the thousands of combinations of drugs, services, treatment locations and service providers, among others—and calculating the cost and benefits associated with each portfolio over time in terms of both productivity and revenue, and the risk and returns. The key is to pick the portfolio with the highest returns given an acceptable level of risk. Harmony Gold's approach is expected to reduce treatment cost in pilot programs by 30–40 percent over a two-year period while significantly increasing participation in the treatment program and reducing absenteeism.[15]

LOOKING INTO THE FUTURE: FINANCE EVERYWHERE

Incitec Pivot Ltd. (IPL), a leading producer of fertilizers, is an impressive example of how Finance can help drive strategic and operational change and catalyze business transformation. Setting the tone for transformation at the top, IPL's executive team changed to a value-based management system to get away from a previous single-minded focus on market share or volume gains. Based on a target of 18 percent for return on net assets, which is expected to deliver shareholder returns of around 15-16 percent, IPL's leadership team is able to evaluate investments and performance targets in terms of the gap to market expectations. [16]

In addition, every part of the business, including supply chain, production, R&D and sales, has a Finance team that works closely with corporate management. For example, the manufacturing Finance team reports to the company CFO, who sits in the operations meetings where targets are set and monitored and investment funding is approved. By integrating the Finance function with the supply chain team, IPL is improving forecasting, sales and operations planning, manufacturing and sourcing decisions (such as whether to import or produce locally), and inventory management, resulting in dramatic cost savings. And, by looking at the full cost to service customers and fully understanding customer and product profitability, sales is no longer simply pushing products to unprofitable customers.

Innovation through the Finance function is yet another area in which IPL is making inroads. To serve customers better, IPL is extending credits for fertilizer purchases until after the harvest season. This allows farmers a better cash flow for which they are willing to pay in terms of carried interest payments. For IPL, however, this credit extension is a big item on the balance sheet, which makes it difficult for the company to meet investor expectations in terms of capital returns. It is removing these debts from the balance sheet by selling the loans to banks on a non-recourse basis. Farmers get easy access to credit, and IPL reduces its invested risk exposure capital, with higher return on net assets as a result.

The advantage of leveraging the Finance function for business transformation can be considerable: IPL has become one of the best-performing companies listed on the Australian stock exchange over the last year.[17]

Companies like IPL demonstrate how Finance can and should become a part of business transformation. The fact that companies will need to transform their businesses in the first place is not in doubt. From globalization, expansion into new markets and low-cost country sourcing, to pursuit of growth through innovation and the ongoing war for talent, the list of challenges facing companies is endless. The current economic downturn doesn't make growth and profitability any easier.

Realizing the importance of Finance as a transformative tool is a big step forward, and the ample benefits gained by finance masters help bring this importance home. Finding the transformation path is harder. But, as illustrated by the experiences of the many companies we have studied around the world, there are abundant opportunities for both leaders and laggards to drive business transformation through Finance with significant impact on business performance.

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Endnotes

1 For a detailed analysis of why financial management and finance transformation can play a key role in resolving these major problems, see Deloitte Research, *Why Finance Transformation Matters in Global Manufacturing* (New York, 2007)

2 See Deloitte Research, *Why Finance Transformation Matters in Global Manufacturing* (New York, 2007)

3 See Deloitte Research, *Mastering Finance in Business: The role and impact of financial management on strategy, operations and business performance* (New York, 2008)

4 See Financial Statement Porsche Group, and Richard Milne, "Porsche profits by CFO's hedges," *Financial Times*, 29 November 2007. On Porsche's use of strategic and operational hedging to create strategic and operational flexibility, see the case on Porsche's Boxster model in Deloitte Research, *Performing Amid Uncertainty: Competing Today and Positioning for Tomorrow* (New York, 2002); and the case on Porsche's Cayenne model in Deloitte Research, *Mastering Complexity in Global Manufacturing: Powering Profits and Growth through Value Chain Synchronization* (New York, 2003); and Deloitte Research, *Mastering Innovation: Exploiting Ideas for Profitable Growth* (New York, 2004)

5 For more on intellectual property valuation, protection and exploitation, see Deloitte Research, *Value, Protect, Exploit: Managing Intellectual Property to Build and Sustain Competitive Advantage* (New York, 2007)

6 The performance of finance masters is significantly higher than that of the other groups studied. Using a rating by respondent based on performance relative to primary competitors, finance masters rate significantly higher than other groups studied across a range of metrics including revenue growth, operating margin (earnings before interest and taxes as a percentage of sales), profitability (after taxes), return to shareholders, and returns on capital/assets. For example, a combined score across these metrics is significantly higher for finance masters than the other groups studied (significant at 93 percent level and higher). Similarly, finance masters rate significantly higher than other groups studied on their level of business capabilities (strategist and catalyst dimensions) in our framework (significant at 95 percent level and higher). While many studies around financial management and its impact on business performance have been conducted over the years, few, if any, have been able to establish a connection between the maturity of financial management capabilities and business performance. Much of the quantitative, statistical research around the benefits of finance transformation has been focused on the cost and efficiency of finance and accounting processes. While this is an important aspect, our research shows that the impact of finance on business improvement and transformation can be a much larger lever for driving performance. For a review of recent studies, see, for example, Jeremy Hope, *Reinventing the CFO: How Financial Managers Can Transform Their Roles and Add Greater Value* (Boston, MA: Harvard Business School Press, 2006)

7 See Deloitte Research, *Why Finance Transformation Matters in Global Manufacturing* (New York, 2007); and Simon Littlewood, "Lean, Mean, Growing Machine," *CFO Asia*, November 2003

8 See Deloitte Research, *The Service Revolution in Global Manufacturing Industries* (New York: 2006)

9 Mark Hillman, "On the Front Lines of Risk Management: Case Studies from the Stanford Supply Chain Forum," *AMR Research*, January 2007

10 Based on a presentation by Eunice Lee, Senior Business Program Manager, Apple, at the Deloitte Research-Stanford Global Supply Chain Management Forum roundtable on enterprise risk management, "Proactive Supply Chain Risk Management," November 14, 2006. See also Hillman, "On the Front Lines of Risk Management," 2007

11 "Company CFOs Who Promote Innovation," *Financial Executive*, October 1, 2007

12 Harmony Gold, *Sustainable Development Report 2007*. In some of the most extreme cases in the mining industry, infection rates can reach 90 percent in some locations and the lifetime cost of treatment US$400,000 to US$900,000 per person. See Mergen Reddy and Boetie Swanepoel, "Cutting the Cost of HIV," *Harvard Business Review*, September 2006

13 Interview with Boetie Swanepoel, CEO of e.com institute (Pty) Ltd., and former senior executive in charge of finance operations, Harmony Gold. See also Mergen Reddy and Boetie Swanepoel, "Cutting the Cost of HIV," *Harvard Business Review*, September 2006

14 See Deloitte Research, *Mastering Finance in Government* (Washington, D.C, 2008)

15 Interview with Boetie Swanepoel, CEO of e.com institute (Pty) Ltd., and former senior executive in charge of finance operations, Harmony Gold. See also Mergen Reddy and Boetie Swanepoel, "Cutting the Cost of HIV," *Harvard Business Review*, September 2006

16 Based on interview with Chris Furnell, Executive Manager, Corporate Finance (in charge of acquisitions and mergers, treasury and funding), Incitec Pivot Ltd

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