FSN White Paper

"Managing Your Business in a Volatile Climate"

A CFO's guide to turning market uncertainty into competitive advantage

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INTRODUCTION

It is often said that, “The only predictable thing about life is its unpredictability.” Change is also a feature of business life— it’s what drives businesses forward; it acts as a spur to organizations to achieve even greater heights. But the last decade has seen unbridled change and volatility on a scale that is unprecedented, punctuated every so often by a mixture of man-made and natural events of breathtaking proportions.

The 2011 Japan earthquake and tsunami disrupted supply chains and the manufacture of essential components in the auto industry and electronics sector across the world in a matter of hours. Unprecedented political events in the Middle East have thrown oil prices, exchange rates, inflation, and economic forecasts into confusion. Sovereign debt has brought countries to the brink of default and threatened contagion across western economies.

Amid the volatility, contradictory or obvious regional variations are adding to the complexity of management decision making. For example, the International Monetary Fund (IMF) at the beginning of 2013 predicted the "beginnings of recovery" in the Eurozone, but at the same time the World Bank downgraded its forecasts for global growth in 2013.

In fact businesses have had to contend with wildly fluctuating rates of decline and recovery across the globe. For instance, US business insolvencies rose by 178% during the recession of 2008-9 while UK insolvencies rose by 57%. Today insolvencies are falling at a faster rate in the US than the UK. US corporates slashed capital expenditure during the downturn but have since raised it by over 20%. UK corporates cut less in the recession but have scarcely increased investment since 2009. Emerging countries escaped the worst ravages of the recession but showed signs of running out of steam in 2012 with, for example, the Reserve Bank of India reducing its main interest rate for the first time in nine months, to 7.75%. However, in China evidence has started to emerge in Q4 2012 of the slowdown drawing to an end. Growth is expected to pick up to 8.3% in 2013 and 9.0% in 2014.[1]

Against this background of volatility, over-regulation has compounded the burden of change. Constant impositions from regulators and global standard-setters have added to systems’ complexity and the breadth of information that organizations need to absorb and synthesize if they are to adequately manage risk.

Even technology is adding to the unsettled picture. The networked economy, hastened by the rapid rise of social networks, mobile, and cloud computing, has brought opportunities, but it has also given rise to unexpected sources of competition as technology lowers the barriers to entry and new business models pop up at a moment’s notice.

1 Ernst & Young Rapid-Growth Markets Forecast Winter edition — January 2013

So, how should companies respond to volatility, and what steps can they take to enhance their competitiveness, financial performance, productivity, and responsiveness in a period of unprecedented and unpredictable change?

HOW WELL HAVE WE COPED WITH THE CHANGING DEMANDS?

Organizations need to be supremely agile in the face of market turmoil but very often their management processes are insufficient to turn volatility to advantage. As a result, few companies are able to drive growth consistently from one decade to another.

A study of the top 1,000 listed companies in the United States over four decades[2] between 1960 to 2004 by professor Gregory Hackett, (formerly a benchmarking guru and professor at Kent State University, Ohio), makes uncomfortable reading. Around 80% of companies are either stagnating or declining. Worse still, the rate of decline is accelerating, with younger companies failing three times faster than they were more than 30 years ago.

Despite the advantages of steadily reducing cost of goods sold over four decades, average profitability declined 40% over the same period. To put the problem into context, half of the companies surveyed make less than 9 days' profit[3]– hardly the foundation of sustainable growth. In fact companies are 3.5 times more unprofitable than they were in 1960.

In addition, management teams have become more risk averse—in some cases frozen to the spot—eschewing bold investment decisions, preferring to hoard cash instead (estimated in October 2012 at US $1.3 trillion; UK £750 billion) [4].

Yet the apparent reluctance to do anything significant with these vast sums of capital is severely at odds with the market opportunity. For instance, McKinsey estimates that by 2025, emerging markets could account for more than 70% of global economic growth yet the largest companies headquartered in developed economies currently derive only 17%of their revenues from emerging markets.

So what is going wrong? What are the key processes and technologies that will allow management to not only ride out, but succeed during this market volatility, more keenly identify opportunities, objectively assess the risks involved, and exploit them for competitive advantage?

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2 "Why Companies Fail" Gregory P Hackett, Goodyear Executive Professor, Kent State University 2007

3 This calculated by dividing net income by the number of selling days.

4 Deloitte study "Show me the Money" (October 2012)

HOW SHOULD COMPANIES RESPOND TO UNCERTAINTIES IN VOLATILE CLIMATES?

When the business is changing at 'Twitter speed' it is vital that management is measuring the right things, forecasting accurately, and managing risk to its advantage.

Measuring the right things

Central to the responsiveness of an organization is the quality of its data management information and the key performance indicators (KPIs) it uses to identify when the organization is out of strategic alignment. Unfortunately, with the accelerating pace of change the task isn't getting any easier. In large and complex heterogeneous organizations the sheer scale of the task makes it extremely difficult to view the overall strategy and check its integrity; let alone cascade it through the organization.

Often, an organization has too many performance indicators and simply achieving organizational alignment of KPIs can seem like a Herculean task. Old KPIs can often go unchallenged while at the same time new 'leading' indicators of performance need to be developed.

There is also a tendency to rely too heavily on trusted financial indicators of performance rather than less familiar non-financial indicators. The latter are often tightly correlated with future financial performance.

More frequent and accurate forecasting

When faced with a fragile global economy and increased volatility, it is important to increase the frequency of forecasting, constantly testing the temperature of the water, formulating scenarios, assessing risk, and assigning probabilities. Increased confidence in forecasting accuracy is one of the immutable bedrocks of sustainable growth—possibly survival as well.

But when it comes to forecasting accuracy, the majority of companies do not get anywhere near the mark. According to one study[5], only 1% of firms hit forecast exactly and just 22% come within 5% either way. On average, forecasts are off by 13% (calculated as the mean absolute deviation from actual results).

Furthermore, too many companies cling to the traditional budget as their principal performance benchmark. But the artificial horizon of the annual budget, coupled with associated forecast revisions, prevent forecasting accuracy. Rolling forecasts, which as the name suggests, are based on a rolling 12-month or-4-quarter timeframe and are regarded as delivering superior accuracy for businesses facing constant change.

5 Report: Forecasting with Confidence; Economist Intelligence Unit/KPMG 2007

According to one survey,[6] over two-thirds of organizations currently use rolling forecasts in some form, and 40% of them believe that they will increase forecasting confidence in doing so.

Broadening the reach of management input also pays dividends, as capturing the perspectives of managers in different functional areas (integrated business planning) provides more 'texture' to the forecast. This horizontal alignment across the different functional areas of a business ensures that plans in one area are consistent with another, and performance measures are rationalized so that satisfying a performance objective in one place does not have unforeseen consequences in another. Going the 'extra mile' by providing a comprehensive cross-functional view of the forecast enhances the quality and the robustness of the projections, thus improving confidence when navigating unprecedented volatility.

Managing risk for competitive advantage

A key feature of a volatile economy is that opportunities continually ebb and flow. Sifting out these opportunities and acting decisively ahead of less agile competitors can sometimes create a competitive advantage that is sustainable in the long term, displacing markets on the wane and acting as a springboard for yet more growth.

The difficulty is that these fleeting opportunities are often accompanied by greater risk, yet a 2011 survey of risk management practices[7] suggests that, on average, around one-third of large companies do not have an enterprise risk management program in place.

Even in the areas that are considered to be most volatile, namely financial and strategic risk, relatively few companies use technology to continuously monitor risks. Instead, more than two-thirds[8] say they only periodically monitor risk across the organization.

The challenge of tackling risk on an enterprise-wide scale is formidable, but it is possible to stack the odds in favor of the organization by adopting best practices, tools, and techniques—in addition to leveraging an appropriate blend of organizational structure, process, and technology. Underlying the whole response is the need for a methodology that focuses the organization's efforts based on the likelihood of an incident and its significance. This can be documented and quantified according to the preferred methodology.

Once the nature of the risk is understood and quantified, it can then drive the type of response. Risk mitigation measures can be developed and key risk indicators (KRIs) established for monitoring and reporting on risk containment. Crucially, KRIs should be incorporated into forecasts and reported alongside the financial results to which they relate.

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6 Report: Forecasting with Confidence; Economist Intelligence Unit/KPMG 2007

7 Accenture 2011 Global Risk Management Study

8 Deloitte and Forbes Aftershock; Adjusting to the new world of risk management.

According to one recent survey[9] risk management practices at top-performing companies are now more closely integrated with strategic planning and are conducted proactively, with an eye on how such capabilities can help by accelerating the growth into new markets or other expansion strategies.

In extremely volatile markets it is important that companies look beyond limited sensitivity analysis in their planning and forecasting to better balance their appetite (or capacity) for risk and their ability to manage risk.[10]

"Once we start thinking about forecasting under conditions of uncertainty of sudden change, it becomes clear that a single forecast value for each time period is simply unrealistic. At such times it is obvious that any forecast could be increased or decreased by 5%, 10%, or more, without flying in the face of common sense. In circumstances such as these it is irrational to issue a single-valued forecast. What is needed is a range of forecast scenarios based on different assumptions in order to understand the resulting risk range." [11]

The notion that risk management is all about harm (or avoiding it) is misguided. Harnessed in the right way, risk management gives organizations 'permission' to pursue new products, business acquisitions, and ventures in foreign markets with confidence in the knowledge that risk has been factored into the decision The good news is that forward-thinking companies are becoming more aware of their shortcomings in risk management—a full 91% say[12] that their companies plan to reorganize and reprioritize their approaches to risk management in some form in the next three years.

LEVERAGING NEW TECHNOLOGIES

Most C-level executives say the three key trends in digital business—namely Big Data and analytics, digital marketing, and social-media tools—and the use of new delivery platforms such as cloud computing and mobility, are strategic priorities for their businesses. Over a third predict that these technologies will boost operating profits by 10% over the next three years[13]. Clearly the stakes are high and companies that fail to exploit these technologies are at serious risk of being left behind.

An additional report[14] dissects these technologies even further, ranking them according to their importance to CFOs. Mobile and cloud computing platforms ranked highest in terms of business value, earning 46% and 33% of the ranking, respectively, followed by Big Data with 14%. CFOs only allocated 6% of their votes to social media and social networking

9 Avoiding Profit Warnings, Metapraxis Limited 2005
10 Avoiding Profit Warnings, Metapraxis Limited 2005
11 Avoiding Profit Warnings, Metapraxis Limited 2005
12 Deloitte and Forbes Aftershock; Adjusting to the new world of risk management.
13 McKinsey Global Survey: Minding your digital business
14 FEI-Oracle webcast, August 7, 2012

technologies, reflecting the skepticism many CFOs feel about the value of social business. Nevertheless, each of these technologies will significantly shape the way that companies operate and compete in the foreseeable future.

Cloud computing

The Cloud computing 'ecosystem' is developing rapidly, and most companies have either 'dipped their toes in the water' or are actively considering the benefits of the cloud. In the next three years, 53% of CFOs estimate that over half of their enterprise transactions will be delivered through the cloud, up from the 12% who use that delivery mechanism today[15].

The initial advantages of the cloud, such as the ability to yield responsibility for overseeing, managing, operating, and supporting the computing environment are well understood by CFOs, but as the cloud matures, businesses are looking for more long-term benefits. Paramount among these is the positive impact that the cloud can have on a business' ability to respond to market volatility. The cloud offers the prospect of more malleable processes coupled with scalability, flexibility, and agility.

Rather than view the cloud just as a cost-saving platform, CFOs increasingly recognize the strategic benefits that the cloud delivers to get critical growth initiatives up and running quickly; whether using the cloud to quickly upgrade to a new application, or simply delivering new mobile or analytical capabilities to employees.

Big Data

The notion of Big Data is not entirely new. After all, CFOs are accustomed to dealing with increasing volumes of information. So why all the fuss? The answer is that Big Data takes 'large' to an entirely new level (zettabytes); not just in the amount of information available, but in the economic opportunities that data can generate.

There are, however, other reasons that make the issues of Big Data both unique and urgent. First, the gap between the opportunities afforded by Big Data and an organization's capability to exploit it is widening by the second. For example, data is expected to grow globally by 40% per year, but growth in IT spending is languishing at just 5%[16].

Second, businesses are being ravaged simultaneously by the twin challenges of rampant economic, regulatory, and market change and unprecedented volatility. As a result, there is intense interest in the technologies and techniques that can provide an edge in analyzing market trends quickly to stay ahead of competitors.

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15 Van Decker, John, "Top 10 Findings From Gartner's Financial Executives International CFO Technology Study", May 16, 2012, p. 13.
16 Big Data: The next frontier for innovation, competition and productivity, McKinsey Global Institute, June 2011

Third, stirred by Big Data successes reported in the retail, healthcare, and financial services sectors, among others, some market observers contend that we are at a point of inflection, meaning that Big Data really is the catalyst for entirely new growth opportunities, products, and services.

Yet few organizations today are well positioned to take advantage of the profit opportunities afforded by Big Data. Leading up to 2015, more than 85% of Fortune 500 organizations will fail in effectively exploiting Big Data for competitive advantage.[17] Most organizations are being held back by fractured information systems, poor data management, insufficient database, and hardware performance, as well as limited access to leading-edge data discovery and visualization tools.

Fourth, there will be an acute shortage of personnel with the deep analytical skills necessary to leverage the full value from Big Data initiatives.

Social media

Social networking and social media are transforming the way that businesses go to market. Initially, the focus of social media was on externally facing campaigns, for example, to accelerate and broaden brand awareness as well as encourage innovation capitalizing on leading- edge techniques such as crowd-sourcing. However, it is internally sponsored initiatives that are now capturing the imagination within organizations that are beginning to use social tools for enhanced collaboration, knowledge sharing, and crowd-sourced innovation—often at very little cost.

ERP vendors at the leading edge of social business are incorporating social tools as a best practice in their user interface, enhancing navigation, streamlining communications, reducing the learning curve, enhancing the user experience, and improving overall productivity. The user interface is where social business crystallizes, i.e., where social networks, social tools, and social business merge in a way that can profoundly change the way that individuals work—helping organizations to respond rapidly to change and volatility.

Mobile computing

As the speed of decision making becomes mission critical, delivering business insight to mobile devices is becoming an essential element of a holistic approach to performance management and business intelligence. Mobile work forces need and expect the convenience of having business information at their fingertips, to be alerted to business anomalies, or to be able to act on the next step in an intricate workflow. In fact, according

17 "2011 Global Shared Services Survey" Deloitte

to a June 2012 CFO Magazine survey, 89% of CFOs rank mobility as the number one technology of importance to their company's success over the next three years.

The opportunities afforded by mobile technology are undeniable. They range from pure convenience, i.e., the ability to retrieve information from corporate systems in real time any way and anywhere on their mobile device where important decisions can be made on the fly. We are approaching a new era of mobile business intelligence (BI) in which Gartner claims that the mobile device is no longer seen as the endpoint of an information flow, but can equally be considered a data generation point—using location-specific information and images to enrich corporate data on people, customers, suppliers, products, and personnel.

The ability to access information literally at one's fingertips is alluring. Gartner adds that by 2014, 90% of companies will support their applications on personal mobile devices. In fact, the analyst firm says that by 2015, mobile application development projects will outnumber native PC projects by a ratio of 4:1. And with mobile technology accounting for around 30% to 50% of the average company's IT budget, CFOs will undoubtedly feel the need to be intimately involved in investment decisions.

By any measure, mobile technology will be a game-changer, helping to make both smarter and faster business decisions, resulting in heightened productivity gains and business agility in a challenging volatile economy.

HONING EXISTING PROCESSES AND TECHNOLOGY INVESTMENTS

In addition to a renewed focus on risk management, business forecasting, and new technologies, businesses can improve their responsiveness to volatility by capitalizing on core processes. Finely tuned processes encourage business agility, helping organizations to take advantage of fewer options and opportunities as they arise. But there are wide disparities between the very best and worst performers. For example, world-class organizations employ 53% fewer full time equivalents (FTEs) and their total finance costs as a percentage of revenue (0.61%) is 47% lower.[18]

But what are the processes that can make a difference? The answer is, to some extent, driven by the unique characteristics of each industry sector, but underlying these special traits is a common set of processes, which can confer significant economic, operational, and strategic advantage regardless of industry.

Working capital management

The management of working capital provides fertile territory for improving margins and providing a funding source to meet the challenges of volatility head-on. Historically companies are relatively poor at authorizing employees to manage the cash flow

18 Deloitte and Forbes Aftershock; Adjusting to the new world of risk management.

consequences of operational decisions. Capital is effectively provided free-of-charge, so that managers are neither aware of the internal cost of working capital nor penalized (or rewarded) for managing it within limits.

Yet managing cash is one of the simplest best practices to implement. Take, for example, the procure-to-pay (P2P) cycle. Unapproved spending on unauthorized suppliers typically accounts for around 38% of all transactions in a business that does not have its purchasing under effective control. Every purchase made from an unauthorized supplier sacrifices approximately 11% in negotiated discounts had the orders been placed with approved suppliers instead.[19]

Modern applications that provide 24-7 access to tools, such as online-catalogues, custom pricing, and paperless supplier orders, can dramatically improve P2P efficiency. In the same way, suppliers can capitalize on the same systems to better control their end of the supply chain, improving service, reducing paper flow, and bottlenecks. As a result, P2P is becoming a strategic tool in managing the global supply chain.

Profitability management

Coupling traditional activity-based costing (ABC) with transaction-based profitability management infuses an organization with exceptional strategic capability, turning the mere management of profit margins into a powerful strategic tool.

Profitability management allows, for example, profitability to be traced over the lifetime of a customer and can be used to position new product and service offerings with customer segments at the appropriate time. The ability to modify customer price plans in response to customer attributes and market volatility can serve to discourage unprofitable or high maintenance relationships and encourage desirable shifts in customer behavior elsewhere.

Performance management

According to PwC, leading finance teams spend 17% less time on data gathering and 25% more time on analysis than typical finance functions. Added to which, leading finance teams report results 30% to 40% faster than typical functions.[20]

Finely tuned performance management can result in greater business agility and competitiveness. Take for instance financial reporting, which for too many businesses is still hindered by cumbersome and unwieldy spreadsheet-bound activities. Excellence in the record to report process ensures that organizations can deliver their results to internal and external stakeholders in accelerated timescales, providing superior insight as well as a high level of confidence in management reports, disclosures, and filings. Collectively, this reflects

19 web3 - Source to Pay (S2P) – a new paradigm in the mid-market, FSN October 2010

20 Putting your Business on the front foot. PwC Finance effectiveness benchmark study 2012

well on the company and its share price, allowing it to tap into a variety of sources of capital and make acquisitions on more favorable terms than its competitors.

Business intelligence

Fragmented systems and loosely coupled architectures, bound together by thousands of uncontrollable spreadsheets, expose businesses to unacceptable delays and an increased risk of error in the face of market uncertainty. Highly qualified financial analysts are left high and dry—compelled to spend the bulk of their time manipulating ageing data rather than analyzing current business performance.

Several clear trends are emerging that are proving to be critical to better decision making. The most fundamental of these is the requirement for a unified analytical platform so that performance management and business intelligence applications share the same data and metadata—structural information such as account codes, organizational hierarchy, and cost centers. The second trend is the move towards a more powerful and responsive analytical capability. A combination of in-memory computing, pre-packaged analytics, and business intelligence capability embedded in financial and other applications sets the scene for real-time decision making.

Supporting these trends are workflow and other collaborative tools such as task management. These are indispensable tools of the modern competitive information environment, linking users in different functional areas to the overarching business process, allowing the seamless transmission of information between them while providing better visibility of processes across the enterprise. The automatic routing and escalation of issues and performance measures increases organizational responsiveness, especially the ability to take decisions.

Dashboards and scorecards provide a valuable way of distilling vast quantities of information into meaningful key performance indicators, gauges, and charts; as such they form an essential component of an analytical platform, focusing decision makers on areas needing attention while delivering to them the actionable information on which to base smarter decisions.

SUMMARY

Companies have faced the most challenging economic conditions for more than 60 years yet for the fleetest organizations; market volatility provides unique opportunities for growth and owning market share. Historically businesses have not fared too well in periods of uncertainty and many have failed to prosper in the long term, apparently unable to take decisions that would secure their future.

The key to riding out volatility is to have the confidence to invest, and this is heavily contingent on measuring the right things, improving the accuracy of forecasts, and having a healthy attitude toward risk. Successful businesses know how to not only balance business risk but confidently take it on.

In addition, recent changes in technology, such as cloud computing, mobile computing, Big Data, and social tools are increasing the possibility for growth despite heightened market volatility. Most C-level executives consider that these technologies could add as much as 10% to the bottom line over the next three years.

But managing volatility for competitive advantage is also about refining existing processes to streamline efficiencies and improve business agility. The reported gap that exists between the best and worst performing companies highlights the potential for improvement in working capital management, profitability management, performance management, and business intelligence.

History has proven that companies that are willing to do what it takes in difficult circumstances while leveraging available technology will ensure they have a business advantage not only for today but also for decades to come.

About FSN

FSN Publishing Limited is an independent research, news and publishing organization catering for the needs of the finance function. This white paper is written by Gary Simon, Group Publisher of FSN (Financial Systems News) and Managing Editor of FSN Newswire. He is a graduate of London University, a Fellow of the Institute of Chartered Accountants in England and Wales and a Fellow of the British Computer Society with more than 27 years experience of implementing management and financial reporting systems. Formerly a partner in Deloitte for more than 16 years, he has led some of the most complex information management assignments for global enterprises in the private and public sector.

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