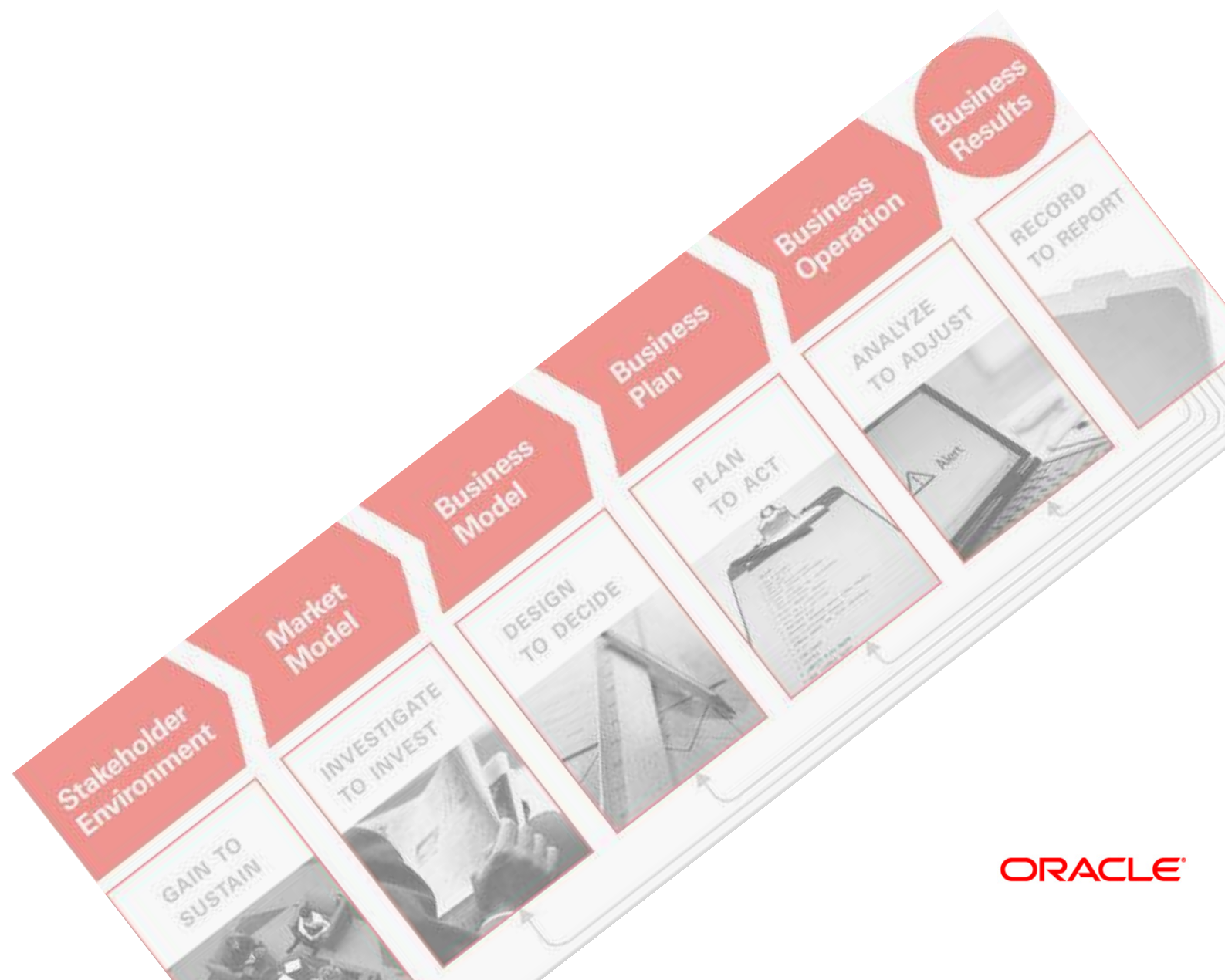


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Journal of Management Excellence: Creating Value



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Letter from the Editor



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Creating value is the most important objective of every organization, but it is also the hardest to define. Creating *shareholder* value is perhaps the most tangible way of looking at value creation. We can look at the market capitalization, net present value of expected dividend streams, and the share price. Maybe the fact that it is relatively easy to measure and calculate shareholder value has been an important reason behind the popularity of the concept. But because something is *easy* to measure doesn't mean that it is the *right* measure of success.

I've come to think of creating value as the role an organization plays within its performance network. For me, an organization is a unique collaboration between stakeholders who realize that individual goals can only be reached by working together. One of the articles in this issue defines the True Value Index, a measure that takes such collaboration into account. Regardless of whether you believe in stakeholder value or shareholder value, you probably agree that profit is important for any commercial organization. It is the oxygen of a company; it keeps the organization alive and allows it to sustain and grow. In today's market, there is particularly heightened interest in managing profitability, and VJ Lal's article sheds some light on how this works.

To understand profitability—or any other key performance indicator—a good enterprise performance management (EPM) system is required to obtain the right data, to distribute the correct information to the right people, and to analyze the results. Ivo Bauermann describes what an EPM system needs to look like to be up to the task. James Taylor warns against the opposite effect. We should avoid the overinstrumented enterprise, otherwise we only keep track of the score instead of focusing on the actual game—running a business. This Journal also includes an interesting case study that, coincidentally, comes from my home country, The Netherlands. Centraal Boekhuis is the main logistics provider for the local book publishing industry. It uses business intelligence (BI) not only to support management decision-making and reporting, but also to share information with stakeholders. In fact, information is a service that Centraal Boekhuis sells. In this case, BI creates value very directly.

As with our previous topic (Organizing for Management Excellence), we will devote two issues to the subject of creating value. Please contact me to submit an article for the next Journal.

frank

PS. Previous issues of the Journal can be downloaded at
http://www.oracle.com/solutions/business_intelligence/resource-library-whitepapers.html#jou

Connect Enterprise Performance Management Processes to Drive Business Value



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During a conversation about performance management, the director of accounting and control at one of our customers said, “Although I need to focus more on control to help drive the business, my agenda is primarily driven by accounting.” This company had designed an important value management process, but it had not been able to fully implement the process due to changing accounting standards and regulatory compliance regulations.

Sound familiar? Although multiple studies among finance executives indicate that the finance department has the opportunity to play a more strategic role, most are primarily focused on regulatory compliance and corporate governance issues. While compliance and governance are very important, it often seems the balance has been tipped towards risk aversion

and away from value-creating behavior. Companies have lost focus of their true purpose: to create and sustain business value.

Is Value Being Destroyed?

A survey by Booz Allen Hamilton concluded “more shareholder value has been wiped out in the past five years as a result of mismanagement and bad execution of strategy than was lost through all the recent compliance scandals combined.” While companies are focused on regulatory compliance, it seems that value destruction should be a greater cause for concern. Although the Sarbanes-Oxley Act brought much needed transparency and a restoration of investors’ trust, according to Booz Allen’s study, it “does little to protect the primary strategic and operational elements that [. . .] are the primary cause of shareholder value destruction.”

Isn’t it senior management’s responsibility to understand and manage a company’s value creation capabilities? Unfortunately a survey by McKinsey reports that, “It is surprising how many executives don’t know exactly how their business units create value.” Ouch. Fortunately, the CFO and the finance organization can play a critical and strategic role in encouraging value-based thinking in managing the business.

The case of one of the largest spirits and wine companies is illustrative. For this company, it was no longer sufficient to manage performance by region or product. Research has shown that brand-guided, as opposed to product driven, companies have almost double the profit margins

compared to the industry average. The finance department decided to analyze different scenarios on margins and investment requirements by brand. Today, the company understands the contribution each brand makes to the company's share price and they can allocate resources based on value-added potential. As a result, the company can manage its business from a value perspective. And the finance department considers the software they use for this analysis "by far the most important analytical tool in the company."

The Convergence of Risk Management and Performance Management

Risk management seeks to *protect* value and this is one of the key objectives of regulatory compliance. On the other hand, performance management seeks to *enhance* or *create* value. Companies need to find a balance between risk management and performance management. The good news is that accounting standards boards have begun to adopt the central idea of fair or economic value. This means that financial reporting—traditionally focused on historical figures—should also give insight into the future cash flows of a company. As a result, the concepts used for value management now form a highly relevant basis for valuation in accordance with accounting standards. This gives finance organizations an opportunity to bring a balanced focus to enterprise performance management (EPM) by meeting regulatory compliance and accounting standards requirements and by pursuing value management activities.

Close the Loop Between Planning and Reporting

Imagine if you could be less concerned with explaining past performance and instead could focus on managing future results. Wouldn't that put you in a better position to drive business performance and value? To focus on the future, companies must avoid the biggest disconnect in management processes: the gap between the backward-looking reporting process and the forward-looking planning process.

Typically, the reporting process answers questions about *what* happened to the business and *why* it happened. Reporting looks at actual results and historical information. A common goal for most, if not all, companies is to be able to report or rely on a single version of the truth. Often this goal becomes the focal point of companies' EPM initiatives. However, having a single version of the truth is only one side of the coin. If reporting is about collecting the facts to construct a single version of the past, then planning is about making assumptions to assess multiple versions of the future. Planning answers questions about *what* could happen and *how* it could be made to happen. If companies want to plan well, they need to enter the realm of simulation. And they had better be good at it because of the impact on value. For example, brand value is determined by expected future cash flows and the business drivers and assumptions behind it. Given most companies' complex business environments, this requires sophisticated financial modeling.

How do you prioritize investments and allocate capital to optimize the return on your product portfolio? To answer this question, you must go beyond simply looking at top-line growth and expenses. Instead, you must estimate expected cash flows and determine if there is a financing

surplus or deficit. Does your capital structure support this strategy? Do you have enough cash to make investments? If not, is there enough capacity to take on additional debt or issue more shares? Will you generate sufficient cash to service the debt and provide a solid shareholder return? What is the impact on your credit rating or your bank covenants such as interest coverage ratios? These questions must be answered so managers can make the right decisions that impact the company's business value.

A good example is provided by one of the top global engineering companies. A few years ago the company found itself in financial trouble. It lost its investment-grade credit rating and, as a consequence, its line of credit. To overcome the liquidity crisis, the finance team understood that they urgently needed to recapitalize the balance sheet. They ran simulations on the company's capital structure and future cash generation. The results were presented to creditors and rating agencies that gained renewed confidence in the company's financial position. Most impressive was how accurate the finance team's simulation results proved to be: actual net income for 2005 was within 3 percent of the projection made in 2003. Such accurate forecasting was a sign to stakeholders that the company again had its business under control. By 2006, the company returned to an investment-grade credit rating.

Connect All Levels of the Company

A common myopia of EPM initiatives is that they often center mostly on the corporate function. But if companies want to truly drive and enhance their business value, shouldn't EPM encompass the entire business rather than just corporate performance? If companies limit the scope of an EPM project to the corporate function, they risk overlooking the specifics that affect business units. A corporate approach to EPM tends to be purely financially driven, rather than an examination of the true business and operational drivers of value.

Conclusion

EPM is most effective when management processes are seamlessly integrated across functions. Sharing strategic, financial, and operational information in an integrated way increases the success of EPM initiatives. When executed properly, EPM serves the needs of both the corporate functions and the business units (and/or divisions and operating companies). It ensures corporate consistency in order to gain insight into overall company performance, while simultaneously providing enough flexibility for business units to manage their specific performance and business drivers. Unfortunately, there is no one-size-fits-all approach to EPM. Companies lured by overly simplistic approaches to EPM run the risk of ineffective implementations. Simple approaches to EPM may sound attractive, but if it were truly easy then every company—including your competitors—would be doing it effectively. It is because EPM is not so easy that your company can use it to gain competitive advantage. Leading companies understand that a more sophisticated approach to EPM puts them ahead of competitors. And this creates opportunities to enhance the value of the business.

Commentary: If You Are Ready, Now Is the Time!



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“A downturn is a terrible thing to waste. It's easier for everyone to understand the need for the change when things are tough and the risks are lower.”

Frank Blake, CEO, Home Depot
Wall Street Journal, June 2008

In this severe economic downturn, the majority of organizations are focused on survival. Their goals and objectives are focused on weathering the recession until better economic times return, and their strategy will be simply to cut costs. They will keep doing the same old things—just less of them. This approach may keep the organization alive during the recession, but it will most certainly result in a weakened competitive presence in the marketplace. Such companies will be poorly positioned to take advantage of the economic upturn when it occurs. After two decades of favorable economic conditions, management teams may have forgotten that growth follows a slowdown. In the past 150 years, there have been more than 30 recessions and each time, within a year, better times have returned.

The better-prepared organizations will treat this recession differently. As pointed out by the McKinsey Global Survey in November 2008, “Fact: 34 percent of companies worldwide are introducing new products and services to gain market share from weakened competitors.” There may be some element of cost reduction in their strategies, but the significant focus is on doing business differently. These forward-thinking companies realize this recession—and the disruption to business as usual—offers the opportunity to transform their business. These organizations will not only survive the economic downturn but will emerge stronger and better prepared for growth.

What does it mean to be better prepared? The management team of a well-prepared organization can very quickly analyze the vast amount of information that is available and understand how the markets are changing and where opportunities are emerging. Such an organization has the management processes in place that allow its managers to take decisive action and then monitor the results of these actions. This allows them to make corrections and adjustments during execution. In addition, a well-prepared company's management processes ensure the alignment of the organization. This allows the company to minimize the potential of wasting constrained resources on nonessential activities. In short, better prepared means these organizations have the management processes and systems in place that enable them to be smart, agile, and aligned.

The Boston Consulting Group defined a pyramid of ambition in the article “Winning in a Downturn,” published in the fall of 2008. Where an organization falls on the pyramid will be a

direct reflection of its willingness to treat a downturn as an opportunity rather than a threat. How well the organization will perform will be a reflection of the maturity of its management processes and its ability to achieve management excellence. If you have ambition but are not prepared, the results will be disastrous. While you may have the desire to reach the summit of Mount Everest, it is better to refrain from climbing if you are unprepared.



Figure 1. The pyramid of ambition as defined by the Boston Consulting Group

If your organization has not invested in enterprise performance management and does not have the management processes and systems in place to take advantage of this current economic downturn, don't be disappointed. There is still time to get ready for the next one. And there will always be a next one.

The Need for Profitability Management



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Profitability and cost management (PCM) is at the core of management excellence because it represents the bottom-line for every company. Not a new discipline, PCM's predecessors include activity-based costing (ABC) that became popular in the late 1980s and early 1990s.

Although profitability management comprises both the revenue and cost side of the business, there is usually a stronger focus on cost management, particularly indirect costs. Indirect costs are all costs not directly associated with the production and sale of products and services, such as marketing, finance, and human resources. It is usually clear which product was sold to which customer. It is also obvious when a product shipped or a service was delivered so that revenue can be counted in a particular period. However, it is much more difficult to attribute revenue to organizational divisions, business units, or departments. It is also challenging to allocate overhead and other forms of indirect costs to business processes.

PCM is a key methodology for linking financial and operational management processes. This allows operational managers to understand the financial consequences of their operational business decisions. Further, it allows financial managers to increase financial control and the predictability of financial results. PCM is often needed to calculate the right performance indicators that organizations track in their (balanced) scorecards, particularly when scorecards need to be cascaded deeper into the organization. PCM is also a key methodology when introducing rolling forecasts as part of the budgeting and planning processes. Rolling forecasts tend to be operational in nature. They translate changes in an organization's activities and available resources into new financial results.

Today, PCM is more relevant than ever. There are multiple reasons for this, both on the tactical side (responding to internal and external pressures) and from a strategic point of view (increasing the organization's competitiveness).

Indirect Costs Are Increasing

Despite modern systems to track all kinds of data, the amount of indirect cost is increasing. For instance, many organizations are introducing shared service centers and centralizing certain operations, either in the front or back office. Economies of scale justify the existence of such centralized operations, but the overhead and other indirect costs still need to be allocated. PCM helps ensure the business relevance of shared service centers. PCM can also help establish whether these shared service centers should be placed within the organization or be outsourced.

In such an exercise, the burden of internal indirect costs can be compared and benchmarked against external services.

Competing on Service, Portfolio, and Brand

In many industries, the quality of individual products does not make a competitive difference anymore. It is the service that comes with the product that makes the difference. As an analytical tool to optimize processes, ABC had a strong focus on the back office. PCM, however, can be used for service pricing where the relationship between resources, activities, and revenues is not always easy to make.

In other cases, products and services are only competitive as part of an overall portfolio. Current innovation often comes from product integration. Think of a telecom offering “triple play” services that integrate telephony, internet, and television. Or consider a financial institution offering start-up entrepreneurs a package of banking products and insurance to make it easier to start a business. Or imagine a European railway introducing a “mobility concept” involving public transportation, taxi pickups, and bicycle rental. The examples can be found across many industries worldwide. Increasingly, these portfolios of products and services do not come from a single organization, but are the result of collaboration across an ecosystem of partners. PCM helps to allocate the right costs and revenues.

Customer Self-Service Business Models

Most modern business models rely on a high degree of customer self-service. Airline passengers check themselves in via the Web, a call center, or machines at the airport. Consumers provide and input their own specifications for custom athletic shoes, cars, insurance, music collections, and many other products. They can even change their preferences up until the last possible moment. Through mass customization principles, customers have taken over business processes. Because they provide the specifications, every single transaction is potentially different. Because they choose the contact channels—the Web, the call center, or retail stores—they determine the time and the order of the transaction. This impacts all dimensions of profitability, including customer, product, and channel profitability. In fact, it calls for tight monitoring and dynamic pricing to ensure transaction profitability. PCM provides a framework to introduce such a level of control.

Business Pressures

Stakeholders such as customers, suppliers, shareholders, regulators, and society at large demand more transparency. Executives cannot allow surprises regarding their profitability. They need to ensure that both cost and revenue are managed in alignment throughout the organization. A solid set of processes, a comprehensive methodology, and a robust system are needed to meet these requirements. In fact, if executives do not ensure such a level of control in a highly regulated

world, it will cost them dearly. After regulatory demands, more transparent competition also pressures margins. Business processes and operations need to be continuously monitored. Moreover, with current economic uncertainty, there is an increased focus on understanding profitability and costs to drive business efficiency.

The Profitability Life Cycle

Introducing PCM is a comprehensive initiative. It involves mastering a methodology, understanding the business drivers, changing business processes, and introducing a system. Most organizations go through a maturity lifecycle for PCM. This profitability maturity lifecycle is largely implicit—organizations go through an evolution without realizing they are moving from one stage to another. The stages, however, are distinct.

In the first stage, at the macro level, profitability is simple, easy to measure, and straightforward to evaluate: $\text{revenue} - \text{cost} - \text{expenses} = \text{profit}$. But quickly the need for deeper understanding emerges. In the second stage, the organization starts *reporting* the key performance indicators of profitability that drive their business, such as cost of goods sold, service and support cost, and product margins. Next, the question stage emerges. Why are some customers profitable and others not? Why do the costs of service go up for certain products? A deeper *analysis* is needed, requiring a more robust analytical system. In the final stage of the profitability maturity lifecycle, an organization develops a plan of action to improve the profitability of its underperforming assets—those customers and products that fall below the line. Profitability *optimization* and profitability *planning* are introduced. Organizations that have fully matured see PCM not as an after-the-fact analysis or a top-down plan. Instead, it is incorporated into every single transaction and built into the core business processes.

Conclusion

Prior to implementing PCM, organizations need to assess their current situation and identify their position in the profitability maturity life cycle. Then they must define their particular business case. This can be tactical in nature and can focus on cost management. PCM can also be strategic in nature. It can be used to enhance the business model—enabling portfolio management, customer self-service, and value chain integration through horizontal alignment. Organizations need not focus on PCM as single discipline. Rather, PCM should be seen as a fundamental part of an overall enterprise performance management system.

Commentary: The Complete Value of an Enterprise Performance Management System



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As I discussed in a previous issue, information is not an asset that can be quantified and put in the balance sheet. Nevertheless the value of an enterprise performance management (EPM) system is derived from its ability to increase both *efficiency* and *effectiveness*.

It is clear that implementing an EPM system has a positive effect on the bottom line by increasing efficiency and productivity. Activities that were previously performed manually—typically disconnected in desktop tools—are automated, standardized, and integrated. For example, a planning process can be performed in half the time with half the resources. However, efficiency gains only count for part of the value an EPM system needs to provide. The second aspect of value created addresses the top line. Effectiveness is determined by the quality of the decision made based on the quality of the information

available at the time the decision is made. The McKinsey survey entitled “How Companies Make Good Decisions” explicitly identified the importance of established decision-making processes. According to the discussion of results in the December 2008 edition of the *McKinsey Quarterly*, “Decisions made at companies without any strategic planning process are twice as likely to have generated extremely poor results as extremely good ones—more than a fifth of them generated revenue 75 percent or more below expectations.”

In his 2006 book entitled *Why Can't You Just Give Me the Number?*, Patrick Leach pointed out “all of management’s value is derived from managing uncertainty.” This interesting quote leads to the conclusion that the real value of an EPM system lies in how the system enables management to better deal with uncertainties. While writing *The Age of Uncertainty* in 1977, John Kenneth Galbraith defined uncertainty as “the difference between the amount of information required to perform a specific task and the amount of information already possessed by an organization.”

Closing this information gap with the technology we have today begins with delivering existing information such as historical or actual data. “Real-time” and “pervasive” are the two key requirements for such data. Existing information needs to be available in almost real time, and access to the information needs to be pervasive so that everybody who needs the information can obtain it. But new information is also produced within an EPM system—in particular, anything that is forward looking, such as operational plans, scenario analyses, simulations.

I doubt the survival of companies that believe that an EPM system is “nice to have” but not a “must have.” With uncertainty and volatility in our global economic system at high levels, the efficiency and effectiveness that an EPM system creates is critical to a company’s ability to compete and endure.

Centraal Boekhuis: Creating Value by Delivering Business Intelligence as a Service



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As the link between publisher and bookseller, Centraal Boekhuis (CB) is the leading logistic service provider in the Dutch book market. Almost every Dutch and Flemish publisher stocks its portfolio of titles from within the CB warehouse. CB offers booksellers access to more than 80,000 titles from which to purchase books. In 2008, CB distributed more than 70 million books from 500 publishers to 1,500 booksellers. But CB does more than store and distribute books. It also handles invoicing, accounting, and cash flow management, and it provides customers with information. As an industrywide service provider, CB's processes are a combination of the insourced, primary business processes of the publisher, the bookseller, and itself.

Understanding Business Intelligence

Understanding the true value of business intelligence (BI) begins with a good definition and an understanding of the information cycle. CB defines BI as doing business aided by knowledge. Data can only become information if it fits a certain context and if it makes sense. Information is meant to provide insight so that something can be learned. In other words, adding sense and notion to data creates information.



Figure 1. The information cycle adds knowledge to data to create information that is then integrated into business processes.

What is done with the information depends on the recipient. When experience, competence, and attitude are added to information, knowledge is created. When you have knowledge, you can act. By acting, you create facts. By having facts, you create data. As illustrated in Figure 1, the information cycle is closely connected to traditional decision-making (the top part of the information cycle). To become actionable (the bottom part of the cycle), it should also be closely integrated with an organization's business processes.

Business Case

With an understanding of the information cycle, we at CB formulated our business case. First, publishers had a critical need for information. With the introduction of a new law in 2005 that banned the fixed price of books, the book market became more competitive. As a result, publishers were looking for a stronger negotiating position with booksellers and needed benchmarking information. As the spider in the center of the web, CB was the logical party to deliver that information. CB recognized that BI was not primarily a tool to support internal decision-making. Rather, BI could be used to strengthen CB's position in the value chain.

The business processes from the publishers can be visualized as shown in Figure 2.



Figure 2. The business process from the publisher's point of view begins with content delivery and ends with royalty payments.

The yellow arrows represent the business processes that are outsourced from the publisher to CB. We asked the publishers to identify the decisions they needed to make at each point in the process. Within stock management, for example, publishers needed to make a decision on whether to reprint a fast-moving book or to move a slow-selling book to clearance. For each business process we determined the decisions that needed to be made and then identified the information required to support those decisions. By focusing every single report on those two criteria, we were able to develop a very powerful business application.

Results Over Time

In the late 1980s, publishers received piles of paper from CB's mainframe. By the mid-1990s, CB made it possible to download the information as an Excel workbook from our server. In the summer of 2003, we started a new project investigating the BI tools market. At first we tried to convince the users—the publishers—that they needed a BI system with key performance indicators on a flashy dashboard. This didn't work. The publishers needed simple, consistent, dynamic reports with the flexibility to sort, apply filters, and drill down into detailed information. We created a powerful application that supports the business functions with lean, yet meaningful, information and a lot of flexibility. There are no fancy dashboards or ad hoc queries, but we do provide consistent, dynamic reports that provide a clear overview of information that supports the publishers' primary business processes.

We decided to give all publishers access to the online BI application as part of our logistics service. We charged no additional fee for the service. However, we charged for an optional module that provides information to support other business processes, such as marketing or content management. This resulted in a very successful BI portal for the publishers.

In a survey, the publishers reported they are better informed, and they rated the application with a score of *good* to *very good*. In addition, over 75 percent of publishers have been using the optional module since its first introduction. We had a full return on investment in less than a year. But the true measure of success lies in supporting the business processes of our customers—the publishers. Book distribution has increased significantly. While the BI application cannot claim full credit for this increase, it surely added some value and contributed to the final result.

Lessons Learned

The development of the BI reports was very successful from a project performance perspective. The whole project was realized within planned time, budget, and scope. The biggest factor for success was doing the project together—incorporating customers, the CB business units, and CB IT. Because IT worked so collaboratively with the customers and business units, IT remained the lead during the entire project. Other important keys to success included the continual focus on simplicity, the clear definition of problems, and the consistency of data.



Figure 3. By understanding the evolution of information formats, CB's IT group was able to anticipate future requests.

During the project, we learned that there are different levels of information presentation. While selling dashboards at the beginning, we discovered a large gap between dashboards and the user's experience with Excel. We had to create very dynamic, flexible reports first. We hoped that the users would follow a natural growth path and request more advanced forms of information sharing at a later date. Consistent with our expectations, the publishers requested that we provide some graphics just one year later. By understanding the various levels and ways that information could be presented we were able to anticipate future requests for information.

Conclusion

BI provides an opportunity to create value when you look beyond the traditional need for internal decision support and realize external requirements for information. For CB, the greatest value creation was in using BI to support the supply chain. A solid understanding of business processes throughout the supply chain was needed to determine what decisions were being made where and when. Then we needed to establish a method to support those decisions with proper information that matched the right level of usefulness for the customer. Because CB was able to understand and address these issues, BI significantly strengthened its commercial results.

Guest Commentary: The Overinstrumented Enterprise



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Performance management systems create value by identifying opportunities or threats. But how much more value could you capture if you could rapidly and accurately change your systems to exploit opportunities or address threats? What if you could look at your dashboard and respond to what you learned by directly changing the way your systems, and thus your company, behave?

Recently, I saw a demonstration of a business activity monitoring solution. The customer was able to get real-time status of every system component in a critical process, but acting on these components—changing them—was still an IT project. In many cases, the availability of information is not the issue. Rather, the decisions are causing your problem. If decisions are made *manually*, then changing how they are made will involve changing a policy manual and retraining all those responsible. If decisions are *automated*, then the decision-making logic is embedded in the systems and processes that handle customers. Changing these systems requires multiple IT projects that consume time and cost money.

To make it easy to change decisions—that is, to build in agility—you need to take a new approach to decision-making. This approach is known as Enterprise Decision Management (EDM). EDM consists of three steps: decision discovery, decision services, and decision analysis.

- Decision discovery separates out the operational decisions in your processes and systems. This allows the decisions to be understood and owned by the business. It allows decision-making to be linked explicitly to performance measures and key performance indicators. With this done, it will be clear what changes to decision-making are required to improve any given measure.
- Decision services use business rules and analytics to improve decisions and to make them widely available to business processes. Creating them separately from your processes and systems enables them to be updated independently. The same business users of the performance management environment can manage the rules and make the changes required as soon as they see a need. This eliminates the time lag between insight and action.
- Decision analysis allows performance management techniques to be applied directly to decisions to ensure they are continually tuned and improved to maximize business performance.

It's not the information that creates value, but the decision-making processes. By focusing on the decisions that create value, companies become more profitable, more agile, and more focused.

True Value Index: A Measure for Sustainable Business Success



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Most corporate scandals, spectacular business failures, and even the bursting of the dotcom bubble were caused by the same phenomenon: organizations forgetting about their core business and value drivers. Think of the retail, telecom, and media businesses that saw their operating companies as cash machines to finance acquisitions, rather than focusing on innovative ways to service customers. While pursuing profit maximization and shareholder value, it is easy to lose touch with reality. The test to see where you are is very simple. Ask yourself one question: *Why are you profitable?* If you can answer that question, the next question is: *Do you know if your sources of profit are sustainable?*

Some organizations see the world of business as a zero-sum game. Their value creation is someone else's value destruction. That is not sustainable. Other organizations aim to add value to their stakeholders and see profits as a reward that can be reinvested in activities that add even greater value. This forms a virtuous circle and is a more sustainable view.

How do we measure if an organization's profit is sustainable? Accounting regulations have not been helpful—perhaps they may have even harmed. Under accounting rules, the value of a pharmaceutical company, for example, would be the book value of assets. Not counting intellectual property, brand value, technology, or patents greatly underestimates a company's value.

I think we need a new measure. I'd like to introduce the true value index¹ (TVI) that builds on operational margin. Roughly, operational margin can be defined as total revenue minus the cost of business. However, four factors need to be taken into account to assess the true value created.

$$\text{TVI} = (\text{Operating margin} - X) / \text{Operating margin}$$

$$X = \text{Unfair procurement savings (X1)} + \text{intransparent margin (X2)} + \text{margin from nonprimary sources (X3)} - \text{unnecessary cost (X4)}$$

¹ I would like to thank Professor Wim Schepers and Stefan van Duin of Deloitte; Ron Dimon of Business Foundation; and Ivo Bauermann, John O'Rourke, and Nigel Youell of Oracle for their contributions.

Procurement Savings (X1)

There is nothing wrong with strong negotiations between an organization and its suppliers as long as it does not result in squeezing the supplier below a fair margin. Even if the procurement cost leads to lower consumer prices, there is a negative effect on the value chain. It creates weak links and suboptimal results. Leaving a supplier a fair margin and inviting that supplier to closely integrate administrative and logistical processes and systems could easily lead to higher—and more sustainable—cost savings. Organizations should assess the parts of their procurement savings that are unhealthy. This measurement constitutes X1.

Intransparent Margins (X2)

There are two sources of profit. The first is based on true added value and a fair premium. The second is based on market opacity or intransparencies—that is, customers not knowing the same product or service can be obtained elsewhere at a better price. Lack of information, limited market access, or even price cartels all cause murkiness in the market. With globalization and the increased buyer power, markets move more towards a model of pure competition where neither buyers nor sellers have the power to alter the market price. Organizations should assess to what extent their profits are based on a fair premium and what part is based on a lack of transparency within markets. This measure is factor X2.

Margin from Nonprimary Sources (X3)

Organizations' income comes from different sources. However, the true value index should count only the income from the organization's core businesses. Of course, treasury should contribute to income, but it should not be considered the core business. In fact, if the return of treasury is higher than the return on the core business, the organization is in the wrong business or has serious issues with its business model! Also, margin coming from activities not central to operations should be evaluated. If such margin is deemed vital, then that activity should become a core activity and be managed as such. If it is not central to the business, it should be discounted from the true value calculation. Margin from activities not central to the business forms X3.

Unnecessary Cost (X4)

Calculating the TVI should not lead you to believe that only direct costs are healthy. If this were the case, there would be no brand marketing, just lead generation; no investments in IT infrastructure, just tactical implementation; and no innovation, just milking the cash cows. However, organizations may sponsor activities that cannot be linked to business results or social relevance. When organizations build up excessive cost, some must be trimmed. The assessment of these costs leads to X4.

How Do You Measure the Total Value Index?

If your TVI index is lower than two thirds or 75 percent, for example, you could say you are in trouble or about to hit it. As you can see, TVI is not really a mathematical formula. It consists of various assessments, particularly of what to call fair and what not. Where does smart business stop and shortsightedness start? But whether the TVI is calculated through self-assessment or is supported by consultants, all the elements of the index are measurable.

First, trust is required to assess the margin of your suppliers. If there is an open relationship and commitment at both sides of the table, it makes sense to openly discuss the health of the relationship. In the automotive industry, for example, manufacturers help suppliers improve business operations and margins so that everyone benefits. Second, the margin based on a lack of transparency in the market can be measured. It consists of an assessment of the actual price of the products, minus the premium you can charge because of your brand value, minus the price of a comparable non-branded product. The amount that remains unexplained is the margin at risk. Finally, measuring the revenue that accrues from activities not central to the business is easy as well, but cost allocations may be needed to assess the associated margins. Assessing unnecessary cost is a very “soft” exercise, but no different from any other cost-saving initiative.

Conclusion

The principles underlying TVI are as old as control theory. Accountants audit a company by aligning money, information, and the flow of goods—or core business processes, in more modern terms. It begins to go wrong when information is lacking or when money flows do not align anymore to the core business process.

TVI is not the only performance indicator that aims to predict business success. The most well known indicator is economic value added (EVA) which includes a charge against profit for the cost of capital. With this charge, EVA penalizes inappropriate behaviors at least in X3 and X4. But EVA will not tell you if your strategy to create value is “right”. Another indicator—aimed at predicting bankruptcy—is Altman’s Z-score. But again, this indicator does not account for “fairness”. There are many initiatives aimed at measuring and managing intangible value such as social responsibility and morality, but most do not claim to have any predictive value for company success. However, TVI alone is not enough. You could allow suppliers a fair margin, have an appropriate nonprimary income, try to not fool your customers . . . and still fail. TVI must be used in addition to other critical performance indicators.

Some say, “Let the numbers speak for themselves” as they search for objectivity. But determining an organization’s TVI is *intentionally* a highly subjective exercise. The discussion around the various assumptions and evaluations may be as important as the actual result. The purpose of TVI is to manage a company by value, not by accounting rules.

Could the TVI be a better predictive indicator for business success – or failure?

Industry Insights



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The following summarized articles provide some suggestions for further reading on the topic of value creation.

“Creating Value Together,” *MIT Sloan Management Review*, Fall 2008

While conventional wisdom indicates that dependencies on partners and suppliers pose a risk to performance, this article highlights research that found “if smartly managed, dependence on one’s business partners brings significant benefits to value creation in interorganizational relations” and can boost a firm’s performance. The research by Professor Ranjay Gulati of Harvard Business School and Maxim Sytch, a doctoral candidate at Northwestern’s Kellogg School of Management, details the nature and dimensions of these successful, symbiotic relations and can be found at:
<http://sloanreview.mit.edu/the-magazine/articles/2008/fall/50108/creating-value-together/>

“The Return of the Strategist: Creating Value with M&A in Downturns,” Boston Consulting Group, May 13, 2008

Researchers Jeff Gell, Dr. Jens Kengelbach, and Alexander Roos at Boston Consulting Group (BCG) published their findings based on an analysis of more than 5,100 merger and acquisition and divestiture deals. They found that regardless of the economic conditions, buyers and sellers can “create significant value.” While the global credit crisis has majorly impacted the number and size of deals—particularly highly levered projects, there are still deals being done that are indeed creating value. For a copy of the report, or to see a video discussion with the authors go to:
http://www.bcg.com/impact_expertise/publications/publication_list.jsp?pubid=2655

“Lessons in Leadership,” *Profit Online Magazine*, February 2009

The most recent issue of Oracle’s *Profit* magazine includes an article that describes Oracle’s own efforts in strategic planning, its customer-centric orientation, the benefits of deploying its own technologies and solutions, and using acquisitions to create long-term shareholder and customer value. To see how Oracle has applied the concepts of performance and management excellence for its own operations, check out:
http://www.oracle.com/profit/exec/122208_savings_.html

“The Value Creation Imperative” and “Maximizing Shareholder Value: An Ethical Responsibility?” INSEAD Knowledge Portal

INSEAD, a preeminent global business school, offers a best-of-business research portal that has an array of articles, pod casts, and RSS feeds on the latest management issues and trends. In a short article entitled “The Value Creation Imperative” and an accompanying video interview, INSEAD Professor of Finance Kevin Kaiser discusses his belief that managers can create value with every decision if they follow his five guidelines. To see Kaiser’s guidelines and interview, visit the INSEAD Knowledge site at: <http://knowledge.insead.edu/valuecreation080103.cfm>.

For an interesting counterpoint and a perspective on the debate that ethics and shareholder value are diametrically opposed, view Finance Professor Theo Vermaelen's article and interview entitled “Maximizing Shareholder Value: An Ethical Responsibility?” at <http://knowledge.insead.edu/valuecreation080103.cfm>.

The Value Creation Index at Value Based Management.net

A great resource and jumping off point for anyone interested in value creation is the Value Based Management.net Web site. The site provides a value creation repository with topics that range from value mapping and Cranfield University’s performance prism to CapGemini’s value creation index (VCI). To learn about the nonfinancial performance valuation metrics used in the VCI or to connect to the site, go to: http://www.valuebasedmanagement.net/methods_valuecreationindex.html

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