“Margin Pressure”

The strategic and operational response to sustaining profit margins in challenging markets

A FSN & Oracle White Paper
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Why are margins under pressure?

Businesses across the globe face a crisis of confidence arising from the worst trading conditions for more than half a century. The "credit crunch" in 2008 followed by the "Euro crisis" in 2011 has left many market observers questioning the prospects for jobs, economic recovery and spending. Geopolitical events coupled with natural disasters have added to the economic uncertainty. The price of computer hard drives has almost doubled following the Japanese tsunami and crude oil prices are once again in the ascendency – closely tracking tensions in the Middle East.

But the picture is not uniform and neither is it all gloomy. Contradictory or regional variations are adding to the complexity of management decision making, especially the ability to set pricing policy and control margins. For example, the US economy created 200,000 jobs in December 2011, much higher than economists' expectations while China's premier Wen Jiabao warned simultaneously that business conditions in China were worsening. Luxury carmaker Bentley added to the picture of confusion when it announced that it had sold more cars in China than in the UK, for the first time in its 90 year history.

The internet too is having a profound impact on companies' ability to control margins. In a highly competitive global environment, winning and retaining new business can be very costly. Consumers in retail banking and telecommunications, for example, are increasingly savvy. Backed by internet resources such as price comparison sites and downloadable Apps they can shuffle between suppliers at a moment's notice and well before the initial costs of attracting their business are recovered.

Competitive edge gained through product innovation that might once upon a time have guaranteed suppliers a price advantage now turns out to be short-lived as the rapid flow of information enables products to be copied much faster. Counterfeiting and theft of intellectual property, ranging from high fashion designs to the latest music, has added to the erosion of margins in creative industries.

In the face of downward pressure on prices, rising and volatile input costs, many organizations have cut costs to the bone. So where else can businesses turn to improve their margins and stack the odds more in their favor?

How well have we coped with the changing demands?

For many industry sectors the ability to measure, say, customer, channel and product profitability remains a significant challenge. Traditional costing approaches such as Activity Based Costing provide insights into the activities that drive costs but depend on sophisticated modeling systems that are unable to cope with the very high transaction volumes that are commonplace in so many consumer facing businesses.

Faced with this dilemma many organizations compromise on the quality of management information and are compelled to rely on summary reports which merely show the total revenues earned and volume of business placed by key customers. Mired in inappropriate systems many are forced to forgo profitability management beyond simple contribution reporting.

Limitations on the effectiveness of margin analysis and reporting have repercussions for other management processes too. For example, an appreciation of working capital and the management processes which drive it is essential for maximizing margins and planning for their steady improvement. Yet working capital and the KPI's by which it is measured do not always factor in management decision making outside of the finance function. Managers are often given Profit & Loss responsibility but this is not always matched by accountability for the 'cost of capital' tied up in their part of the business.

This lack of target setting around working capital also has implications for the way that business plans and forecasts are developed, for example, the timing of receivables and payables as well as setting in place best practice processes including competitive benchmarking that challenge existing processes of managing, cash, inventory, debtors and creditors.

However, due regard also has to be given to risk. For example, an unbridled attempt to shorten debtor days may lead to an undesirable loss of customers and similarly, increasing margins by a change in product/sales mix could adversely affect market share. Recent events in the financial services sector illustrate the undesirability of companies chasing better margins and a bigger slice of the market without taking full account of risk in their business plans.
From the above it can be seen that any remedy or improvement initiative has to be broadly scoped to accommodate a wide range of processes, information systems and organizational issues. These need to be resolved in tandem if organizations are to make deep inroads into the management of profit margins. So how exactly should companies respond?

Responding adequately to the challenge of maintaining profit margins requires a deft combination of strategic and operational measures since the two are inextricably linked in the performance management cycle. For example, strategic objectives, such as entering new markets and the development of new products can have a direct bearing on projected margin performance captured in business plans and forecasts. In parallel, the active monitoring of margins at an operational level can inform whether the strategy is working and forecasts are achievable – completing the cycle.

The operational response is vested in more pragmatic steps concerning the management of working capital, the introduction of Profitability Management and Activity Based Costing techniques together with better performance management processes and tools such as benchmarking.

Although ‘cost of capital’ is a familiar concept within the finance function it is not always ‘front of mind’ in other functional areas. Managers can be blissfully unaware that maintaining investments in high stock levels, failing to collect debts or keeping cash idle in the bank gives rise to opportunity costs, i.e., the cost of not doing something else. This cost is rarely captured in departmental reporting so that managers often appear to have a ‘free ride’ i.e., do not bear the true cost of doing business and have no awareness of how to manage the working capital tied up in their domain.

Enterprise Performance Management capabilities are crucial to ensuring that any margin improvement initiative is captured as part of the other regular management processes that guide performance in the business. This means that such initiatives should be consistent with strategic objectives, benefit from target setting, budgetary and longer term planning and form a natural part of performance reporting (dashboards, scorecards, operational reporting), analysis and decision making. Embedding margin improvement in the objectives of the business is critical to ensuring enterprise-wide participation in the initiative and ensuring that outcomes are regularly monitored and decisions re-visited in light of over or under-performance.

There is of course an organizational component to managing margins as well - particularly outside of the finance function. Part of the response is to explain to non-finance managers how they can influence margins and to provide the tools (education, reports and scorecards) to help them measure whether they are being successful.

The other component is to use modern technology to drive productivity gains so that the organization can do more with less and keep a firm lid on people costs. Collaborative technologies such as workflow, unified communications and Social Media encourage cross-functional working, improve process visibility and allow organizations to process more work without necessarily adding to headcount, i.e., overheads.

Since people costs can amount to up to 80 percent of direct costs in service based economies the potential to control overheads through the application of the latest technology is a large and potentially rich seam of margin improvement that should not be overlooked.

Whilst most businesses know which channels, products and customer relationships are the most successful in revenue terms, the majority are hard pressed to say which of them generate the most profit. For many, the age old dilemma of whether the most prolific customer relationships are actually the most fruitful remains unresolved. As a result, few companies know where to concentrate effort and resources in the pursuit of better profits. Overspending on loyal customers with a strong propensity to buy is wasteful, yet under spending on customers that are tempted to leave the fold is damaging for the longer term prospects of the business.

However, a generic model or profile of this nature pitched at the level of customer groups and product classes is insufficient in the drive to improve profit margins. Banks, retailers, airlines and many other industries seek to exert their influence at the level of individual customers. But in recent years, the speed at which new products and services are launched combined with more varied channels to
market and a broader portfolio of products has led to increasingly complex interactions. Drawing these threads together in order to arrive at overall customer, channel and product profitability has proven to be extremely challenging.

Re-visiting cost allocation
For the majority of companies identifying profit at the contribution level, (sales minus variable cost of sales) it is derived directly from their Sales Order Processing system. FIFO or weighted average costs and sales prices adjusted for product/customer discounts can be issued directly with ease out of most ERP systems.

But it is the indirect or ‘hidden’ costs of doing business that obscure the truth and provide an unreliable picture of customer, channel and product profitability. This can happen because costs are allocated to products and customers on a fairly arbitrary basis, using, for example, total absorption costing which does not reflect the manner in which costs are incurred in the business. Furthermore, the bland application of overheads (absorbed say on the basis of office floor space) fails to take into account less obvious “Cost Drivers” i.e., an event or factor which causes an activity to be performed, which once appreciated can transform an apparently profitable product into a loss making one.

There are two main approaches toremedying the cost allocation problem, namely: Activity Based Costing and a transaction based approach – sometimes called Profitability Management.

Activity Based Costing (ABC)
ABC overcomes the limitations of traditional costing techniques by focusing on “Activities” (a series of related tasks carried out repeatedly, such as chasing a customer for late payment), “Cost Drivers” (as defined above) and “Process” (a series of activities required to achieve an outcome) and the inter-relationship between them. Using the ABC technique, the business is analyzed into discrete activities (common sense has to be applied to ensure an appropriate level of granularity) and costs derived from the general ledger are assigned to activities on the basis of the most appropriate allocation method, for example, space occupied, number of PC’s and so on. These activity costs are then taken to, say, products, services, channels and customers using the cost drivers of each activity and of course the volume of that driver by product, service or customer.

Although most businesses can be amply described by around thirty to forty cost drivers such as number of export customers, customer returns, cheques processed, policies issued and so on, experience shows that an ABC approach to delivering product/customer profitability quickly runs out of steam.

Whilst the theory is perfectly sound, it is difficult to deliver on an ‘industrial’ scale. The relatively complex algorithms implied by an ABC model do not readily lend themselves to environments with millions of customer interactions, so organizations have to compromise on the granularity of profitability reporting and satisfy themselves with profits cast at a summary level of product and customer group or category.

A further drawback of ABC is that the theory sits well within an accounting environment but does not transcend other functional areas of a business quite as easily. Valuable though it is, businesses also need a more digestible and scalable method of calculating customer and product profitability.

Profitability Management
A “transaction” is a term that occupies a unique position in a business setting. It describes an interaction that it is normally associated with a particular customer and product at the lowest level of granularity in an ERP system and there is little confusion about what it means. Managers from all functional areas appreciate that a transaction can drive costs or revenues or a combination of both. Another advantage of a transaction is that it is the fundamental building block of a business system which means that it fits naturally into reporting hierarchies and roll ups. This means that transactions are readily summarized by customer groups, individual customers, product groups or individual SKUs (Stock Keeping Units), channels or specific branches as a matter of course. It therefore follows that if all attributable costs and revenues are captured at the level of an individual transaction then these can be effortlessly rolled up to produce a profit and loss statement at any level of an organizational hierarchy.

Leveraging Profitability Management and ABC
Identifying the revenue generated by a particular transaction is relatively straightforward but confirming costs is generally more challenging. However, leveraging the information in an ABC model is extremely helpful. Costs are allocated to activities in the usual way but rather than assigning
them to cost objects (such as a product, branch or region) in the normal way, the costs can be taken directly to transactions. Using this technique an organization can take advantage of a sophisticated ABC model to identify the true cost of a transaction whilst simultaneously avoiding the inherent complexities of managing ABC on a large scale.

The ability to marshal millions of transactions and distill individual customer profit and loss places remarkable power in the hand of end users. For the first time, key business insights become accessible at a macro and micro level, i.e., profit trends can be seen at the level of an individual customer as well as customer groupings.

As such, profitability management transcends the boundary that often exists between different functional areas such as marketing and finance functions. By describing profitability in terms of a customer account, the approach lifts the debate about profitability management out of the realms of complex accounting allocations and empowers non-finance managers to understand how profits are generated.

**ResMed significantly improves profitability reporting**

ResMed develops, manufactures, and markets medical products for the screening, treatment, and management of sleep-disordered breathing and other respiratory disorders. Founded in Australia, and now headquartered jointly in Sydney and San Diego, ResMed has manufacturing plants in Los Angeles, Paris, Singapore, and Sydney, and it sells to more than 70 countries through direct offices and distributors.

The company embarked on a project to implement a centralized budgeting and forecasting system to integrate financial information, such as manufacturing and administration costs and to produce detailed profit and loss statements.

As part of the initiative it wanted to provide managers with regular, integrated, in-depth financial reports detailing product sales and overall profit margins as part of its overall objective of growing 15% to 20% per year and developing three product-based strategic business units. Reporting also needed to cope with complex foreign currency calculations to break down profit and loss and cost structures into dollars, sterling, Euros, and other currencies used in the international plants and offices.

Following an initial study of its needs, ResMed engaged Oracle Partner, Qubix, to provide advice on the use of Oracle Hyperion Planning. Following the implementation, this application enabled managers to access ‘see-through’ product and regional profitability data, based on manufacturing costs versus external sales prices without including intercompany transfer prices and mark-ups. It also enabled in-depth monthly ‘see-through’ product profitability reports covering individual countries and strategic business units, compared to a less-detailed quarterly global report. It also created comprehensive financial month-end reports on a more detailed country-by-country basis providing in-depth views of how foreign currency rates affected the business by generating profit and loss and cost structure reports based on actual, budget, and year-on-year currency rates.

The project successfully encouraged better regional sales techniques, by focusing on high-margin products and by providing profitability information on a product-by-product basis with continuous monitoring of performance.

**Building profitability drivers into the planning and forecasting process**

Having identified the profit levers in the business it is essential that these findings are integrated with business plans and forecasts so that impact on margins can be modeled. For example, the simultaneous ability to model revenue by product and customer incorporating the appropriate cost allocations on the way provides a robust basis for assessing the outcome on margins and the resources that need to be deployed for their achievement. The flexibility of a multi-dimensional model which allows the different cost drivers to be flexed in parallel is in sharp contrast to the flat two dimensional world of the spreadsheet.
Coupling traditional ABC with transaction-based Profitability Management imbues an organization with exceptional strategic capability turning the mere management of profit margins into a powerful strategic tool.

Profitability Management allows, for example, customer profitability to be traced over time to provide an insight into how profits develop over the lifetime of the customer. A better understanding of what drives product, channel and customer profitability over the lifetime of a customer can lead to better management decisions around, the ideal customer profile, the attractiveness of different customer segments, and policies around pricing and customer retention. These can in turn be used to inform the creation of more realistic management objectives and strengthen the accuracy of business forecasts.

At a more practical level, this can be managed to strategic advantage to position new product and service offerings with customer segments at the correct time. The ability to flex customer price plans in response to customer attributes and conditions can serve to discourage unprofitable or high maintenance relationships and encourage desirable shifts in customer behavior elsewhere. Having individual or group profitability ‘on tap’ allows marketing resources and campaigns to be deployed with more precision, since bespoke campaigns targeting specific classes or sub-classes of customer groupings become worthwhile when taking a longer term view. Managing profitability in this way also has benefits for the way in which products are tested, marketed and retired. Using multi-dimensional analysis provides insights into product lifecycles and the way that profits build and decay over time. Taking a product oriented view of profitability allows management to keep a watchful eye over new product promotions as well as older product classes that may have lost their appeal and need replacing.

Elkay Manufacturing, Co. drives enterprise-wide transformation to improve profitability

Started nearly a century ago as a father and son business focused on manufacturing stainless steel sinks, Elkay Manufacturing, Co. is now a leading provider of kitchen and bath solutions, including sinks, faucets, water coolers, cabinetry, countertops, food service equipment, and water filtration products. The company has manufacturing facilities in the United States, Mexico, and China.

The company needed to drive a strategic financial management transformation to mitigate the impact of the economic downturn on the construction and renovation industry, as well as the effects of rising commodity prices and increased global competition.

It needed to improve profitability and performance by shifting from a product-centric to a channel-centric organizational structure. It also wanted to reduce business complexity and supply chain volatility and better plan for shifts in commodity prices, market conditions, and demand. Finally it was seeking to improve the accuracy of costing and business profitability analytics.

In order to meet its objectives the company implemented Oracle Hyperion Performance Scorecard and Oracle Business Intelligence Enterprise Edition to support a cultural change to a common strategic planning framework across product lines and channels. The new system was to provide data for board of directors’ reports and quarterly strategy reviews and a framework for strategic alignment.

The new solution supported a shift to a balanced scorecard framework focused on strategy execution, enabling the company to monitor and react quickly to changes in its basic assumptions, such as raw materials costs and changes in market demand. It also provided visibility into costs and profits at company, business unit and channel levels, with drilldown capability all the way to specific sellers and orders. This enabled the sales organization to use profitability analytics to improve strategic relationships with their customers.

As a result of the improvements, the company developed plans to shift away from short-term, budget-focused financial plans and move toward dynamic business planning focused on tracking real-time progress toward long-term strategic goals. This contributed to tangible profitability improvements, despite a significant decline in sales due to a housing industry downturn.
The management of working capital provides fertile territory for improving margins, yet historically companies are relatively poor at empowering employees to manage the cash flow consequences of operational decisions. The focus for many functional/departmental reports is frequently on the profit and loss side rather than the balance sheet so that functional managers are often unaware of whether their operations are generating or consuming cash. Capital is effectively provided ‘free of charge’ so that managers are neither aware of internal cost of working capital nor penalized (or rewarded) for managing it within limits.

Yet managing cash is one of the simplest processes to influence through best practice. For example, the efficacy of the ‘Order to Cash’ cycle is heavily influenced by rapid generation of sales invoices, informing customers a big invoice is on the way (to avoid disputes), invoice accuracy, effective monitoring of aged debtors, and generally leveraging the automated controls for order authorization and credit limit checking that are available in most modern ERP systems.

The ‘Procure to Pay’ cycle is simply a mirror image of the ‘Order to Cash’ process in which the intention is to manage cash closely by taking maximum advantage of the terms agreed with the vendor. Once again this is largely about leveraging the native capabilities of ERP systems to ensure that payments are only made for authorized goods and services ordered and received, that invoices are processed accurately and that pricing, discounts and payment terms comply with what was agreed.

The advent of shared service centers and sophisticated purchase to pay applications (with auction capabilities) can help ensure that processes adhere to best practice and control which suppliers are authorized as well as maximizing the value of bulk purchasing with selected suppliers.

Inventory management is also amenable to best practice management aided by ERP automation. Managing goods to tight re-order levels and ensuring that the business is neither over-stocked nor under-stocked can have a profound impact on the amount of money invested in inventory.

For those organizations that do not habitually measure working capital, the use of scorecards coupled with the development of relevant KPI’s (Days Sales Outstanding, DPO – Days Payables Outstanding, Inventory – Days of Sales, Free Cash Flow, Return on Capital, etc.) ensures that allocating responsibility for the cost of capital and its role in improving profit margins is not overlooked.

Best practice performance reporting helps management make timely and effective decisions in line with the organization’s strategic objectives. But this requires the delivery of actionable information in a way that is meaningful and accessible to managers drawn from different functional areas. As a result a ‘one-size-fits-all’ approach to the delivery of information is unlikely to succeed. Where different techniques are deployed it is essential that information is consistent. For example, margins reported multi-dimensionally, by product group, business unit and customer group provide valuable views of the business but these need to be consistent between dashboards, scorecards and traditional accounting ‘variance’ reports.

Reliable benchmarks embedded in performance reporting inject a degree of objectivity into margin reporting allowing the organization to position its performance relative to peers or similar organizations and providing external challenge to internal assumptions about how well the business is doing. Benchmarking encourages analysis of performance to become more focused and specific, allowing management to identify areas of improvement and to plan for a better allocation of resources in the pursuit of better margin performance.

But with markets moving at “Twitter” speed it is more crucial than ever that all of this information is delivered exactly when and where people need it. Increasingly this means on mobile devices or via self-service reporting applications in the Cloud.

Delivering systems advantage at both a strategic and operational level requires strong capabilities in transaction and information systems. Modern ERP systems should provide the basis for the required level of customer, supplier and inventory analytics but realizing all the productivity gains relies on enabling software for cross-functional working and collaboration, for example, workflow, integrated email and unified communications.
Enterprise Performance Management capability (including Activity Based Costing and Profitability Management) is critical for ensuring that the monitoring, analysis and reporting is interwoven with other performance management processes, such as strategy management, scorecarding, budgeting, planning, forecasting and reporting.

Tight integration between transaction processing (ERP) and Enterprise Performance Management is vital for ensuring that margin reporting and the levers which drive profit improvement are articulated in a meaningful way across functional areas, for example in scorecards so that individual managers understand how their decisions impact profit margins.

Alternative methods of deployment such as Cloud-computing offer businesses the opportunity to leverage functionality that may not be available in legacy systems (for example supplier auctions) and to better align processing costs with the scale of operations. Cloud computing often has the advantage of no upfront costs and a ‘pay for what you consume’ licensing model. This reduces fixed overheads and often makes it more straightforward to identify and allocate costs to different parts of the business, products, customers and channels.

Oracle provides financial management applications that operate at both the strategic and operational levels in an organization. Thousands of organizations globally use Oracle’s Financial Management Solutions to perform strategic and financial planning, manage their day to day financial processes, monitor financial and operational results, analyze profitability, and support critical business decisions. Oracle’s Financial Management Solutions include packaged applications for core financial processing; governance risk and compliance; and enterprise performance management.

The core financial applications include Oracle E-Business Suite, PeopleSoft and JD Edwards Financials as well as the new Oracle Fusion Financials. The core financial applications support comprehensive integrated business processes and include modules for general ledger, payables, payments, and expense processing, receivables, collections and credit management, procurement, assets, and treasury management which all contain automated workflows and approvals and self-service components. While the new Fusion applications feature embedded analytics, all of the core applications are augmented by packaged analytic applications with dashboards, metrics, alerts and the ability to drill from summary levels to operational details for fast analysis and action, when needed. The Fusion applications also feature advanced collaboration and workflow, including integrated social networking to encourage active communications and resolution of business issues.

Oracle’s Hyperion Enterprise Performance Management applications provide an effective solution for integrating and automating strategic, financial and operational management processes. The suite includes packaged applications supporting Strategy Management, Planning and Forecasting, Financial Close and Reporting as well as Profitability and Cost Management. The Profitability and Cost Management applications support the integration of historic financial and operational results, multi-step allocations of revenues and costs using a variety of methods including Activity-Based Costing, and multi-dimensional analysis of operating results by product/service line, customer segment, distribution channels and other lines of business. The cost drivers generated by this module can be leveraged to make operational decisions and in the planning and forecasting for future periods. The Oracle Hyperion suite is complemented by Oracle’s Business Intelligence platform, which provides information delivery capabilities to support a wide variety of needs from graphical dashboards and scorecards, to production reporting, ad reporting, MS Office integration, and mobile information delivery.

Oracle’s Hyperion Enterprise Performance Management applications integrated with and add value to Oracle as well as non-Oracle financial and operational applications. They provide out of the box data and meta data integration with Oracle and SAP financial applications, as well as drill-through and write-back capabilities to enable fast insight to action.

Oracle’s Financial Management Solutions provide flexible deployment options designed to fit the needs and budgets of customers. The applications can be deployed on-premise, via Oracle On-Demand hosting services or via a network of hosting partners. Oracle is starting to offer some of its applications through a Software as a Service (SaaS) model with subscription-based pricing. This is currently limited to Oracle CRM On-Demand, as well as Oracle Fusion CRM and HCM but this could be expanded to its financial applications in the future.
Profit margins are under pressure from a combination of geo-political change, unprecedented economic volatility and structural changes such as the impact of the internet on trading methods. In response to the more testing conditions, businesses have ‘tightened their belts’ and sought to reduce costs. But with an inability to control prices and costs already cut to the bone there are seemingly few places to turn to for improved profitability.

Yet there remain opportunities to improve profit margins by invoking a variety of strategic and operational responses together with organizational change and enabling technology. The strategic response requires a heavier focus on enterprise performance management and specifically incorporating appropriate margin objectives (and KPI’s to measure them) into the regular budgeting, planning and forecasting processes. These need to be rolled out across the enterprise, leveraging score-carding technology and empowering financial and non-financial management to understand the profitability drivers in the business. This is especially true of working capital measures that are often overlooked.

The operational response requires a better understanding of the cost base in order to identify the ‘true’ profitability of products, customers, and channels. The optimum approach is to leverage the capability of ERP systems and profitability management systems to capture costs and revenues at a transaction level and to use ABC techniques to inform the most appropriate way of allocating costs. Benchmarking provides additional objectivity by challenging internally generated assumptions against peers.

Simple, pragmatic steps in relation to working capital management can yield fast results using the native capability of ERP systems and relatively standard operational reporting to enhance controls through the ‘order to cash’, ‘procure to pay’ and ‘inventory management’ processes.

Integration between ERP (transaction systems) and performance management systems is crucial to delivering a joint approach to monitoring margins. This requires investment in suitable tools rather than relying on spreadsheets that cannot handle the required volumes of data or play any meaningful part in collaboration. Finally, the introduction of collaborative technologies can indirectly influence margins by increasing productivity and encouraging better sharing of information and best practice.

Implementing all of these measures together with enhanced performance management reporting gives management the tools to better understand profitability from different perspectives at a granular level. Armed with this information, business leaders can set more confident pricing policies, identify profitable customer, product and channel segments and incorporate appropriate measures in business forecasts and scorecards for their achievement.
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Oracle is the leader in Enterprise Performance Management (EPM), unifying Performance Management applications and Business Intelligence (BI), supporting a broad range of strategic, financial and operational management processes. Oracle provides a complete and integrated system for managing and optimizing enterprise-wide performance. This enables organizations to achieve a state of management excellence, which provides competitive advantage and leverages their operational investments.

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