Trusted Advisor or Compliance Enforcer?

"Can anybody remember when the times were not hard and money not scarce?"
Ralph Waldo Emerson

Of all the various roles Finance can play in life sciences, the two most necessary to balance are complying with legal, tax and accounting regulatory requirements and dispensing sound advice on the efficient allocation of resources. In the first, Finance must focus on checks and controls. In the second, it leverages its extensive expertise in understanding what resources are required to generate which revenues. It is uniquely positioned to play this second role because, while most business departments push as far as they can in a single direction, Finance must evaluate the company's contrasting realities.

How Finance strikes this balance (and many others) to a large measure determines the success or failure of the company. *Is your budget a tool to control costs, or to sponsor investment?* Depending on your market sectors, and where your products are in the product life cycle, one choice is better than the other.

Finance is the mind of the business, using a structured approach to evaluate the soundness of the many business propositions and opportunities you face every day. Information feeds this process, and Finance has more information than most departments. As it fills its role of balancing—aligning processes and controls while advising the business on future directions—Finance faces a number of barriers when it comes to information and how to use it.

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Barrier 1: ***Lack of information needed to regulate what has happened and shape what will happen***

Finance requires new levels of information about past and present processes and events to meet its regulatory compliance responsibilities. *Did the right employee or department sign off a particular expense item? Has Regulatory Affairs signed off on a new product opportunity?* For some companies, the information demands of compliance and control have forged better relationships between Finance and IT. They have led to changes in information gathering and collaboration methods (such as linking disconnected spreadsheets, for example), lowering the control risks these represent.

But while Finance works to manage these issues, it must also ensure the information investment helps drive its other key responsibility: helping guide decisions that make a difference to the future bottom line.

The executive team and sales reps both look to Finance to help the business plan its future with confidence, not simply manage money in and money out. Finance must pay attention to the drivers that make profit, using value-added analysis to extrapolate the impact of these drivers on tomorrow's results—and anticipate them when necessary.

Valuing, monitoring and making decisions about intangible assets exemplifies the interconnection and sophistication of the information Finance requires. Regarding human capital, for example, Human Resources and Finance must work together to identify the value-creating roles of individuals, reflect their worth and manage their growth, rewards and expenses.

Without information sweet spots that show both the status of control and compliance and the impact of drivers on future business opportunities, Finance can't strike the necessary balance.

Barrier 2: ***The relevance, visibility and credibility of what you measure and analyze is designed for accounting rather than business management***

Finance collects, monitors and reports information with distinct legal, tax and organizational requirements to fulfill its fiduciary role. But Finance also needs an integrated view of these and other information silos to fill its role of advisor. This role requires not simply reporting the numbers but adding value to those numbers.

For example, international companies that operate across several countries usually separate sales, R&D and production entities and define an average transfer price to reflect an allocation of cost for these centers. Without see-through profit, a local sales office may cut effort on products that appear to have low local margin or even be loss-making, but in fact still make a positive marginal contribution to the company's profit overall.

Another example: Marketing must understand spending on various activities. Finance must categorize relevant expense accounts across a wide range of detailed and hierarchically complex general ledger accounts. Without this comprehensive view, the same expense may be classified in different accounts by different individuals.

Barrier 3: ***Finance must balance short term and long term, detailed focus and the big picture***

Finance balances different and contradictory requirements. It must deliver on shareholder expectations every 90 days; it must also determine a winning vision and a strategy to achieve that vision over quarters and years. Companies can cut costs and investments to meet short-term profit objectives, but at what point does this affect long-term financial health? This is a particularly difficult balance in the life sciences where substantial investments are being spent upfront before a long-term return can be substantiated. A well-informed executive team is able to understand the drivers, opportunities and threats when balancing short- and long term financial performance.

Executives and financial analysts define performance in terms of shareholder value creation. This makes metrics such as earnings per share (EPS) growth or economic value added (EVA) important. However, these distilled financial measures tell only one piece of the story. You need to augment them with more detailed measures that capture sales, market share gains and revenue growth targets to understand the real health of the company, and strike a good balance between long- and short-term growth.

Barrier 4: ***Finance must find the path between top-down vision and bottom-up circumstances***

To what extent should goals be set top-down versus bottom-up? *If the executive team mandates double-digit profit growth, does this translate into sensible targets at the lower levels of the organization? Does it require a double-digit target at the lowest profit center?* Top-down financial goals must be adjusted to bottom-up realities. Finance must accommodate top-management vision while crafting targets that specific business units can achieve.

This barrier in particular illustrates the importance of engaging frontline managers in financial reporting, planning and budgeting. The need for fast and relevant information requires an interactive model. Frontline managers must assume some budgetary responsibility and feed back changes from various profit or cost centers as market conditions change. This decentralized model engages the business as a whole rather than relying on a centralized function to generate information.

Besides freeing up Finance for value-added decision support, bottom-up participation generates an expense and revenue plan that overcomes hurdles of relevance, visibility and credibility. Individuals who engage in the process take responsibility for delivering on expectations. This helps expose drivers of success and failure that are otherwise lost in a larger cost calculation or financial “bucket”—for both the frontline manager and Finance.

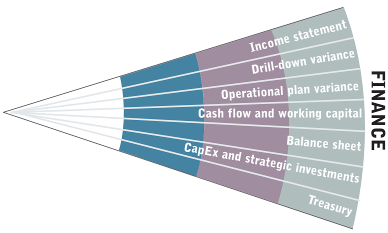
Balancing Short Term and Long Term, Past and Future, Compliance and Advisor

The information Finance uses to report what has happened and shape what will happen is critical to the rest of the organization. Dynamic tools that allow Finance to balance compliance and performance, accounting and business structures, short term and long term, top-down vision and bottom-up reality are more important than ever. Information sweet spots can support Finance's responsibilities and decision areas.

A Balanced Financial Experience

Finance decision areas:

- **Income statement ➔** How did the business team score; where was performance strong or weak?
- **Drill-down variance ➔** What causes changes in financial performance?
- **Operational plan variance ➔** How do we best support, coordinate, and manage the delivery of meaningful plans?
- **Cash flow and working capital ➔** How do we manage working capital, collect accounts receivables and monitor cash use effectively?
- **Balance sheet ➔** How do we balance and structure the financial funding options, resources and risks of the business?
- **CapEx and strategic investments ➔** What are the investment priorities and why?
- **Treasury ➔** How can we efficiently manage cash and liquidity requirements?



Income Statement

This decision area represents the bottom line. It is the cumulative score achieved by everyone in the business for a set period. Everyone needs to understand his or her individual contribution and performance measured against expectations. You must understand where variances above budget occur so you can correct the course. If costs are increasing too quickly, you risk damaging future profits unless you control them, adjust selling prices or develop new products or markets. Unexpected revenue spikes can mean additional resources are required to continue future growth. Adjustments such as these take time: the sooner you take action, the sooner you improve margins and realize the full potential of a growth opportunity. The ability of Finance to quickly identify, analyze and communicate important variances has competitive implications for your company. How quickly the business capitalizes on a new situation is determined by how quickly it discovers budget variances.

GOALS	METRICS	DIMENSIONS
Actual vs. Plan Variance ($/%) Net Sales ($) Operating Profit/EBIT ($/%)	Gross Profit ($/%) Marketing Costs ($/%) R&D Costs ($) Net Profit ($/%) SG&A ($/%) Tax ($/%) Interest ($/%) Fixed Costs ($/%) Variable Costs ($/%) Staff costs ($/%)	Fiscal Month Year Quarter Month Organization Division Department Org. Code Plan/Actual Scenario Scenario Product Line Product Line

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit	Executives			•
	Managers	•		
	Professionals	•		
Customer Service	Executives		•	
Distribution	Executives		•	
Human Resources	Executives		•	
IT / Systems	Executives		•	
Marketing	Executives		•	
Operations / Production	Executives		•	
Purchasing	Executives		•	
Product Development	Executives		•	
Sales	Executives		•	

Drill-Down Variance

Once you identify a difference between actual and plan, you need to drill down into the details to understand what caused it. *If sales increase by five percent between two time periods, was the cause greater volume, a higher effective price or a change in the product mix? Did your competitors have the same increase in sales? If profits increased, was it due to increases in the cost of goods, a change in product mix to lower margin products or a reduction in discretionary spending? Did your competitors experience the same increase?*

Finance needs to understand the why behind changes. Knowing what drove changes in revenue and profit provides a more complete picture to help guide the company.

GOALS	METRICS	DIMENSIONS

Profit Change ($/%)
Sales Change ($/%)
Volume/Price/Mix Variance ($/%)
	Avg. Unit Cost ($) – Actual
	Avg. Unit Cost ($) – St'd
	Discount (%)
	GL Expense Detail ($/%)
	Net Change ($/%)
	Net Price ($)
	Net Sales ($)
	Units Sold (#)
		Billing Customer
		  Category
		  Customer Name
		Fiscal Month
		  Year
		  Quarter
		  Month
		GL Lines
		Organization
		  Division
		  Department
		  Org. Code
		Product SKU
		  Product Line
		  Brand
		  SKU

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance				
	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit				
	Executives			•
	Managers	•		
	Professionals	•		
Customer Service				
	Executives			•
	Analysts		•	
Distribution				
	Executives			•
	Analysts		•	
Marketing				
	Executives			•
	Analysts		•	
Operations / Production				
	Executives			•
	Analysts		•	
Purchasing				
	Executives			•
	Analysts		•	
Product Development				
	Executives			•

Operational Plan Variance

Once Finance understands what caused performance variances, it can lead discussions about future operating plans. The ability to advise and push back on management plans is important. Knowing the why behind variances from plan helps companies re-evaluate and improve the next plan. Without this information, plans lose their purpose and become academic exercises to please senior management. Ideally, Finance offers input and feedback that other business areas can use for guidance. At the same time, these other areas provide front-line information to Finance that helps improve the plan. Such cross-functional and coordinated effort lets you test the roadworthiness of existing business plans.

GOALS	METRICS	DIMENSIONS
Operating Cost Variance ($/%)	Actual vs. Plan (%)	Fiscal Month
Overhead Cost Variance ($/%)	Avg. Unit Cost ($) – Actual	Year
Prod. Cost/Sales Ratio (%)	Avg. Unit Cost ($) – St'd	Quarter
	Distribution Cost ($/%)	Month
	Employees (#)	GL Lines
	Forecast ($)	Organization
	Labor Costs ($/%)	Division
	Marketing Costs ($/%)	Department
	Overhead Costs ($)	Org. Code
	Plan ($)	Plan/Actual Scenario
	Production Costs ($)	Scenario
	Production Hours (#)	Product Line
	Sales per Employee ($)	Product Line

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance				
	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit				
	Executives			•
	Managers	•		
	Professionals	•		
Customer Service				
	Executives			•
	Analysts		•	
Distribution				
	Executives			•
	Analysts		•	
Marketing				
	Executives			•
	Analysts		•	
Operations / Production				
	Executives			•
	Analysts		•	
Purchasing				
	Executives			•
	Analysts		•	
Product Development				
	Executives			•
	Analysts		•	
Sales				
	Executives			•
	Analysts		•	

The nature of the life sciences business model poses a particular challenge for understanding performance and variance in drug discovery and clinical trials. Both areas need to track project-based expenses consistently, both fixed and variable, with input from many different sources (clinical trial managers, laboratories, CROs and financial analysts), in different formats, at different times or at irregular intervals. Effective variance analysis help secure the right mix of resources in the right amount to ensure clinical trials meet their filing dates.

> *"In our supply chain division, we can analyze large volumes of data while still keeping our eye on the detail. And for our Finance team, we have provided a rapid way of gathering financial information and presenting it in an aggregated, consolidated format."*
>
> Markus Barmettler, IT Project Manager, Smith & Nephew Orthopedics AG

Cash Flow and Working Capital

Effective collection of accounts receivable fuels better performance. The cost of delay is high; managing the profiles of aging accounts receivable or the days of sales outstanding (DSO) is a key priority for any company. The flip side of the coin is that delaying your own accounts payable is good for cash flow. In both cases, Finance must have insight into customer and supplier preferences to ensure the bottom line does not damage valuable relationships.

Investment analysts scrutinize working capital requirements as one factor in determining financial performance. *Is the business managing its valuable cash resources? How does the ratio of debtors (accounts receivable) to sales or the DSO compare to the industry average? Are stock days increasing, meaning more cash is being diverted to holding stock? Are the accounts payable days increasing?*

Working capital requirements have a direct impact on the market valuation of a business. They are a critical area for Finance to monitor.

GOALS	METRICS	DIMENSIONS
A/R Days (#)	A/P ($)	C/F Lines
Net Cash Flow ($/%)	A/P to Sales (%)	Class
Working Capital Ratio (%)	A/R ($)	Sub-class
	A/R to Sales (%)	Account
	Current Assets ($)	Fiscal Month
	Current Liabilities ($)	Year
	Inventory ($)	Quarter
	Inventory Days (#)	Month
	Inventory to COGS (%)	Organization
	Net Change ($/%)	Division
	Quick Ratio (%)	Department
		Org. Code

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit	Executives			•
	Managers	•		
	Professionals	•		
Sales	Executives			•
	Analysts		•	
IT / Systems	Executives			•
Marketing	Executives			•
Operations / Production	Executives			•
Product Development	Executives			•

Balance Sheet

This decision area balances the financial structure and resources of the business. How much debt, long and short term, can the business safely take on? For shareholders, a higher debt-to-equity ratio means higher rewards and greater risk. A highly leveraged business will generate attractive financial rewards, but if operating profits fall this may jeopardize the company's ability to deliver on interest and debt repayments. The company's financial structure is a balancing act that must be based on business fundamentals. *Are future market conditions likely to be favorable? Are sales increasing or decreasing? Is more cash investment needed in the company's future assets?* Depending on the strategy and future direction, Finance has to accommodate such demands while maximizing returns. Capital employed—working capital plus fixed assets—and return on capital employed (ROCE) are critical factors that influence how lenders and shareholders value a business.

GOALS	METRICS	DIMENSIONS
Capital Employed ($)	Assets ($)	Bal. Sheet Lines
Debt-to-Equity Ratio (%)	Debt ($)	Class
ROCE (%)	Equity ($)	Sub-class
	Fixed Assets ($)	Fiscal Month
	Fixed Assets/Assets (%)	Year
	Liabilities ($)	Quarter
	Liabilities-to-Equity (%)	Month
	Market Value ($)	Organization
	Sales/Capital Employed (%)	Division
	Sales/Operating Assets (%)	Department
		Org. Code

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance				
	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit				
	Executives			•
	Managers	•		
	Professionals	•		
Marketing				
	Executives			•
Operations / Production				
	Executives			•
Product Development				
	Executives			•
Sales				
	Executives			•

Investors normally perceive an intensive and high-capital-employed industry as more risky and look favorably on those companies that deliver a high ROCE. In this, ROCE reflects how well the business can convert investment or capital into profit. However, the issue is complicated in high R&D sectors such as life sciences, where most of these investments are seen as an expense rather than an asset. The decision to capitalize R&D investment onto a balance sheet can therefore impact investors' views, and the rationale for what gets capitalized and its impact is another balancing act for Finance. Can it effectively communicate the "true" perspective? For example at one level profits are increased if R&D expenses are capitalized, but equally the capital base increases, so Finance must decide which profit measure to use that best reflects established principles and provides a consistent view for investors.

Selling the financial attractiveness of the business to new investors is an important Finance function. ROCE or return on assets (ROA) is a benchmark that reflects positively or negatively on senior management and Finance. But how to position this measure is complex in a high R&D sector business. This leads to the next decision area.

CapEx and Strategic Investments

Since capital expenditure (CapEx) has an impact on ROCE performance, businesses must evaluate and monitor investment decisions carefully. Asset investments can range from minor to strategically significant: from a new computer to a new production plant in a new country. Finance must ensure that CapEx and investment requests don't simply become wish lists. Finance must establish the basis for prioritizing and justifying capital expenditure. This means coordinating with different function areas. For example, Finance must understand the impact of both yes and no before agreeing to new investments in plant and equipment. *Will the business lose sales if you don't build the plant? Will this action fix product quality problems? Will production costs increase or decrease?*

GOALS	METRICS	DIMENSIONS
Investment ($) NPV ($) ROI (%)	Acquisition Profit Growth (%) Acquisition Sales Growth (%) Assets ($) Breakeven Months (#) Capital Employed Change ($/%) Fixed Assets ($) IRR (%) Payback Months (#)	Bal. Sheet Lines Class Sub-class Fiscal Month Year Quarter Month Organization Division Department Org. Code Plan/Actual Scenario Scenario Potential Projects R&D Project Type Project Project Project/Program Type Project

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance				
	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit				
	Executives			•
	Managers	•		
	Professionals	•		
Marketing				
	Executives			•
	Analysts		•	
Operations / Production				
	Executives			•
	Analysts		•	
Product Development				
	Executives			•
	Analysts		•	
Sales				
	Executives			•
	Analysts		•	

Again R&D capitalization becomes an issue, as most R&D is intangible and does not become capitalized until there is a clear scientific achievement or regulatory approval. Regulatory approval gives confidence that pharmaceutical companies can demonstrate a technical proven asset with probable future benefits. In a sense, an R&D commitment is a strategic investment or intangible asset that, if successful, will become a future asset to the business. Finance will therefore be part of these intangible strategic decisions and look to assist in understanding the relative risks and reward scenarios.

Mergers and acquisitions represent another strategic dimension of investments. *What are the potential cost savings from combining these two businesses? If the companies serve the same market, will customers be concerned about high supplier dependency? If the businesses are complementary, what is the volume of incremental sales? How will the intangible assets, such as R&D expenditure be valued in the acquisition pricing process?*

Understanding upside and downside impacts from potential investments is part of the evaluation process. Finance arbitrates such decisions, and requires detailed financial scenarios that forecast investment ROI and payback.

Treasury

Moving beyond the strategic finance structure of the balance sheet, there are regular day-to-day liquidity management concerns that require constant attention. Treasury is concerned with the effective management of cash and liquidity, financing, bank relationships and financial risks. *What are the options for short-term borrowing and cash requirements? Should any surplus cash be placed in the money markets or into a bank account—and if so, at what rate of return and for how long?*

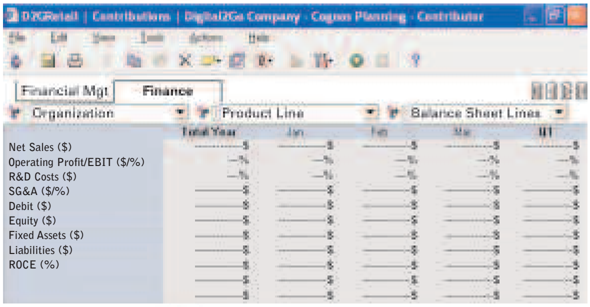
Effectively managing these liquidity options and dealing with bank relationships requires constantly updated information. Having access to current market information and aligning it with future business requirements is the key to effectiveness.

GOALS	METRICS	DIMENSIONS
Borrowing Cost (%)	Shares Issued (#)	Bal. Sheet Lines
Investment Yield (%)	Shares Outstanding (#)	Class
Net Liquidity ($)	Accrued Interest ($)	Sub-class
	Dividend Payments ($/%)	Fiscal Month
	Interest ($/%)	Year
	Investment Risk (#)	Quarter
	Investments ($)	Month
	Loan Balance ($)	Organization
	Net Cash Flow ($)	Division
	Options Outstanding (#)	Department
	Options Paid-Up ($)	Org. Code
	Price Earnings Ratio (#)	
	Repaid ($) – Interest	
	Repaid ($) – Principal	
	U/W Loan Amount ($)	

FUNCTION	DECISION ROLES	PRIMARY WORK	CONTRIBUTORY	STATUS
Finance				
	Executives	•		
	Managers	•		
	Analysts	•		
	Professionals	•		
Audit				
	Executives			•
	Managers	•		
	Professionals	•		

Income Statement
Actual vs. Plan Variance ($/%)
Net Sales ($)
Operating Profit/EBIT ($/%)
R&D Costs ($)
SG&A ($/%)

Balance Sheet
Capital Employed ($)
Debit ($)
Equity ($)
Fixed Assets ($)
Liabilities ($)
ROCE (%)



Dimensions
Fiscal Year/Month/Week
Organization
Product Line
Balance Sheet Accounts

The Income Statement and Balance Sheet decision areas illustrate how the Finance function can monitor its performance, allocate resources and set plans for financial and operational targets.