INTRODUCTION

The ultimate purpose of every customer oriented Telco is to sustain and improve its financial performance. In order to achieve this purpose, the company is divided into units that are more accountable for the company's performance:

- *Customer-Facing Units*[1] *(CFUs),* profit centers that are responsible for maximizing bottom-line performance of their business by concentrating on improving sales, profits and customer satisfaction within a specific market segment. Therefore, CFU Heads should understand every revenue and cost driver under their control, and their performance measurement should be based on the contribution of their Unit to the Telco overall profitability.

- *Shared Resources* and *Corporate Units*[2], cost centers that are responsible for minimizing costs at agreed levels of service (quality and timeliness). They should be evaluated on whether they meet service requirements and on their productivity, efficiency and cost effectiveness.

Unit Financial Reporting (UFR) is conceived as a managerial tool, for all Units, reflecting unit financial performance evolution on all financial business drivers under the Unit Heads' control, to enable managers to make appropriate decisions and to enable the CEO to evaluate those managers on their financial performance for compensation purposes. That is,

- The generation of different types of reports depending on the nature and responsibilities of the Unit (CFUs vs. Network and other Shared Resource Units or Corporate Units)

- A level of disaggregation of costs and revenues that will allow managers to understand the specific drivers affecting the business and make targeted decisions for improvement

- The identification of controllable versus non-controllable items in order to focus managers' attention on those drivers they can take action on and to allow the CEO to use this as a tool for evaluating financial performance and determine compensation

1 CFUs are, for example: Large Clients, Government, Business, Residential, Public Telephony, Interconnection.

2 Shared Resources Units include IT, Purchasing and Logistics, Fleet, Real Estate, Administration and Security. Corporate Units include External/Internal Communications, Finance, Legal, Planning, Human Resources, Regulatory and Corporate Marketing.

- ¶ The use of the reports as the basis for budget construction and its follow-up process
- ¶ The breaking down of real costs into annual unit costs based on the budget, and variances, in order to compensate for forecasting accuracies
- ¶ Identification of the best drivers for revenue and cost attribution
- ¶ The incorporation of benchmarks and market references in order to promote cost effectiveness

The implementation of UFR should be carried out in stages or generations, determined mainly by the sequence of authority delegation to the Units, in addition to availability and quality of the necessary detailed information. Following is a description of the ultimate picture of UFR content (Sections 1 - 3), and the requirements to implement a first generation of reports (Section 4).

The document is divided into the following sections:

1. What should be included in Unit Financial Reports?
2. Which criteria should guide the internal attribution of revenues, costs and balance sheet elements?
3. How should this tool for unit management and performance evaluation be used and administrated?
4. Which steps should be taken to implement Unit Financial Reporting?

1. WHAT SHOULD BE INCLUDED IN UNIT FINANCIAL REPORTS?

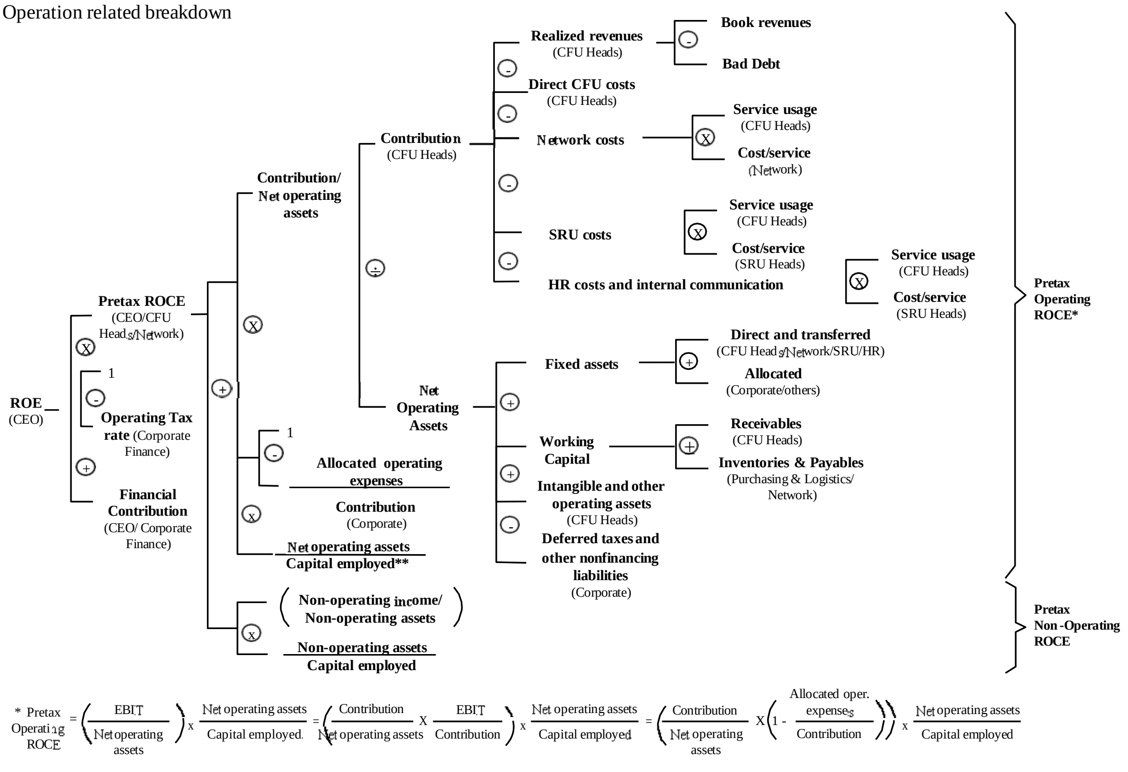
The content of unit financial reports should detail the business drivers controlled by Unit Heads, financial indicators used for their evaluation, and other references that will help them understand the current financial performance level and the feasible potential of increasing profits for the business or reducing the costs for services under their responsibility.

The ultimate financial indicator of the Telco success is its return to shareholders or Return on Equity (ROE). As shown in Exhibit 1, this indicator can be broken down into a set of linked financial drivers of ROE performance that are controlled at different levels and functions of the company. This breakdown helps determine which indicators each Unit should understand, monitor, and report to the CEO.

Exhibit 1

RETURN ON EQUITY TREE

Operation related breakdown



** Capital employed = Operating assets + Non-operating assets (see Attribution of non-operating assets on page 24)

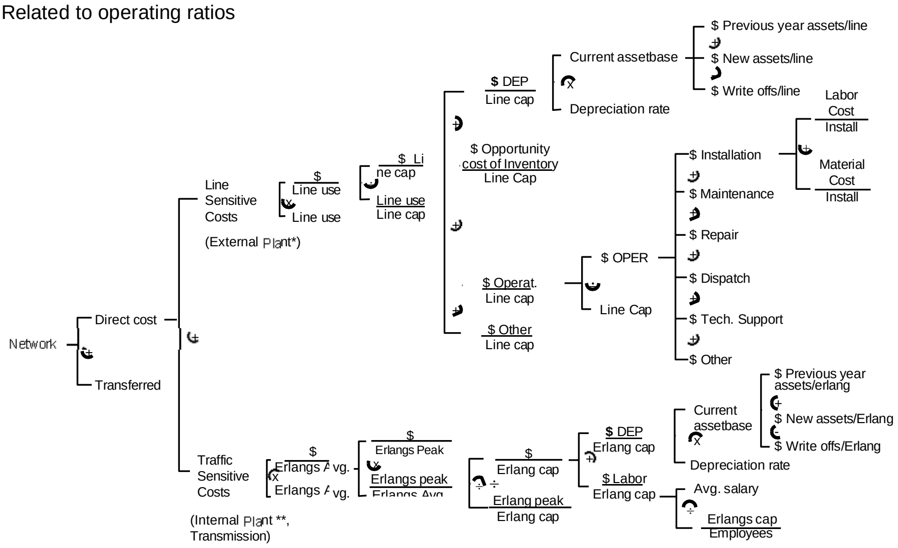
CFUs, for example, set pricing, market and sell products, introduce or discontinue services, decide on support strategies, product and geography mix, and level of resources to use. This means that they can control the contribution of their customer segments to the Telco, by taking actions on the contribution drivers. They should also gain control over resources in SRUs, such as which capital projects to invest in first and how to balance maintenance versus new investments for the network. They should, therefore, be held accountable for most operating assets. This will provide them with the basis for being measured on Operating Return on Capital Employed (Operating ROCE).

Network and other Shared Resource and Corporate Units, on the other hand, manage the level of resources used to provide required services to CFUs and other Units, and make outsourcing and other efficiency improvements decisions. This means that they should be held accountable for service levels provided, for the costs of the services under their responsibility and for the assets they employ in order to provide those services. Exhibit 2 shows a breakdown of costs for the network, that links the different drivers to the ultimate performance indicator. By understanding each of these drivers, network can better manage its responsibilities. A similar breakdown should be used for each SRU and CCU.

Exhibit 2

NETWORK COST AND CAPITAL EFFICIENCY MEASURES

Related to operating ratios



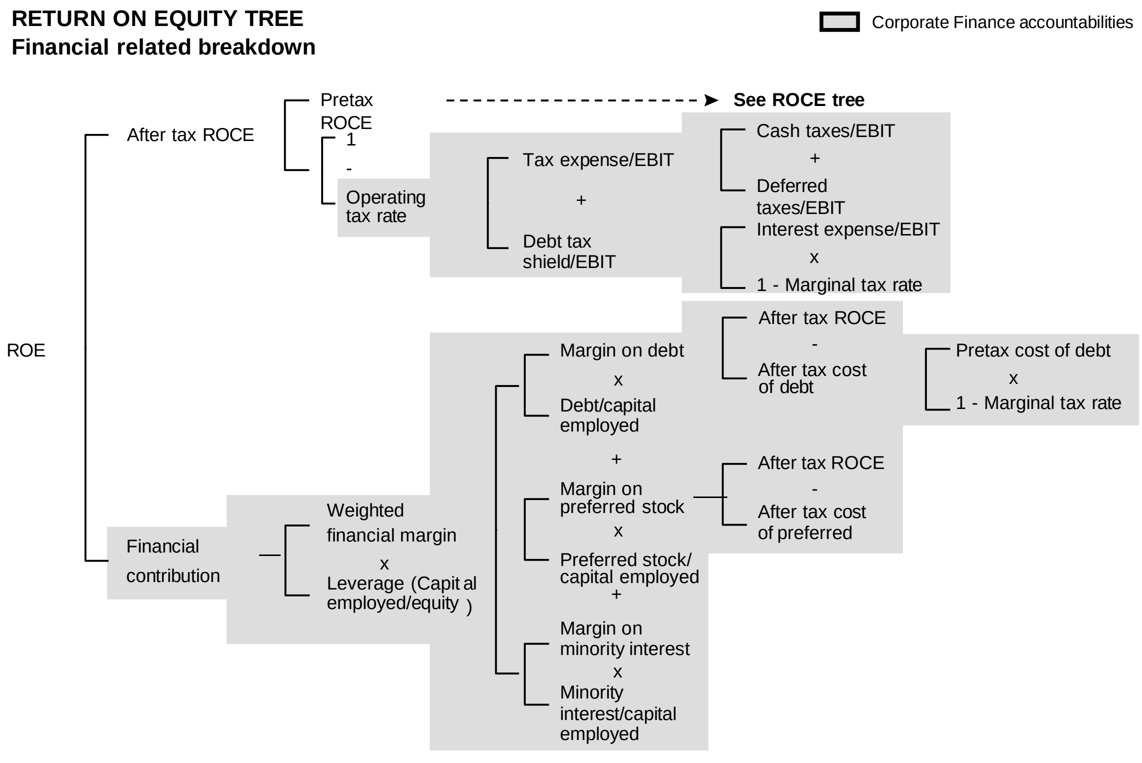
* External Plant includes access and some terminal switching (i.e. total local loop)

** Internal Plant includes Terminal Switching, Junction Network, DLD Switching + Transmission, ILD Switching + Transmission

Source: McKinsey

Corporate Finance is a particular unit, responsible for managing the capital structure, minimizing income tax, optimizing cash management and investments. It is accountable for the Telco's financial contribution and the Telco's non-operating ROCE. Exhibit 3 shows the breakdown of drivers this unit should monitor.

Exhibit 3



Therefore, each unit's report needs to be designed around these different responsibilities.

CFU Reports

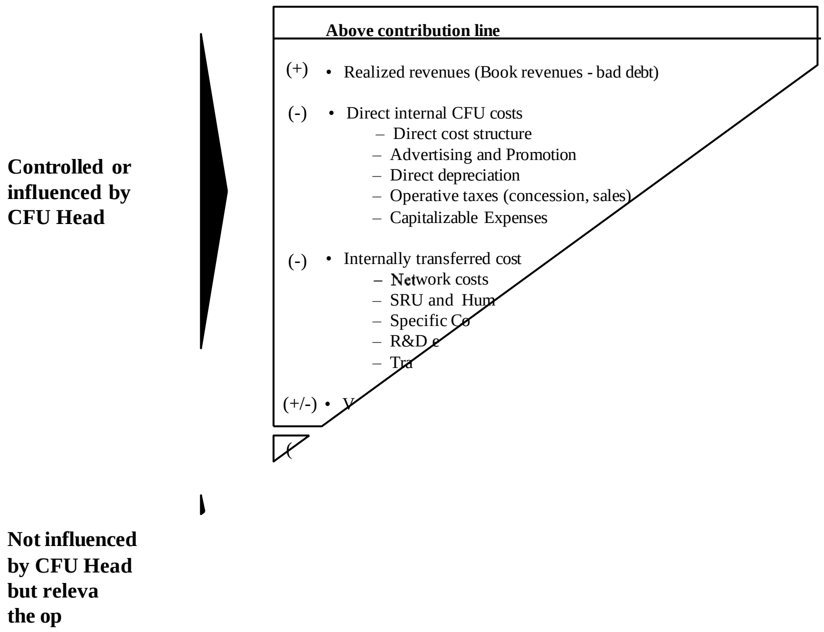
As stated above, CFUs will be held accountable for the profitability of their customers and over the Operating Return on Capital Employed (Operating ROCE) to run the business. Therefore, CFU financial reports should include a Profit and Loss (P&L) statement and a report down to Contribution/Net Operating Assets based on those balance sheet elements that the unit can influence.

As a management and performance evaluation tool, CFU reports should allow an overall understanding of the business development vs. the budget, the historical trends and benchmarks, and an easy assessment of the drivers of contribution and the development of the units' performance on each of them.

The distinction between controllable and non controllable drivers should be reflected on the P&L by using a contribution line to divide revenues and costs, locating controllable revenues and expenses above the line and non-controllable expenses below the line or off the report, as shown in Exhibit 4.

Exhibit 4

PROFIT AND LOSS STATEMENT STRUCTURE
ABOVE AND BELOW THE LINE ATTRIBUTION



The division of expenses should allow CFU Heads to identify those items they can decide upon and therefore be evaluated on, by locating them above the line.

Above the line

The expenses located above the line should include all direct costs and transferred costs that the Unit can control or influence:

- Network costs that are driven by the CFU’s access requirements and service usage
- Shared Resources Costs (e.g., Real Estate, IT, Fleet, etc.), also driven by usage of services, and Human Resources costs that are deployed to support Unit functions (such as recruiting, training and definition of compensation levels)
- Specific Corporate Center expenses that are directly generated by a particular unit (e.g., planning resources dedicated to new product feasibility analysis or issue management related to a specific unit (ATM/Frame Relay for Large and Medium Clients))

- Transfer costs from one division to another, when one unit acts a sales channel for products/services from other unit
- Variances to the budgeted costs (see *Attribution of Variances* on page 22)

Below the line

Although CFU Heads do not control all operative expenses, they should be aware that they exist and are required to run the business. For example, CFU Heads will not have decision-making power or focus efforts on managing most Corporate Center Expenses, but should be aware that these units are necessary to run the business and have an effect on the Telco's bottom-line.

This would be the case for the Regulatory Unit which manages the relationship with the government to set tariffs and handle other business related activities. CFU Heads, although not accountable nor evaluated on these expenses, should have the option of making recommendations on how to better handle them.

The expenses located below the line should include:

- General Corporate Center costs which are difficult to be transferred on a specific driver (Regulatory, Finance, Corporate Communications, and Transformation), and
- Variances to the budgeted costs (See *Attribution of Variances* on page 22)

Off the report

Finally, there are revenues and costs generated by the Telco that are irrelevant to the operations and should therefore be OFF the report. These items would include all elements related to the financial contribution of the company (for example, returns on unrelated investments and other treasury operations, gains/losses on exchange, financial interests on loans) and Corporate Center expenses that are unrelated to the business (for example, related to other subsidiaries or corporate reporting and activities that do not contribute to the Telco business).

Exhibit 5 describes the basic set of detailed information that should be contained in the CFU financial reports.