‘CFO Guides to Digital’: A 3-Part Series of Reports

This is the first in a series of reports focusing on how CFOs can help their organizations set and execute digital strategies that promote digital business optimization and digital business transformation.

The two additional reports in this series are below:

The CFO's Guide to Funding the Enterprise's Digital Investments
View Report

The CFO's Guide to Performance-Managing Enterprise Digital Investments
View Report
Overview

Organizations are accelerating their digital spending in response to disruption in 2020. CFOs must help their leadership teams assess their digital strategies to prevent misplaced digital spend and ensure the business and financial outcomes necessary for future success.

Before accelerating their digital initiatives, CFOs must understand the strategic business outcomes their organizations hope to realize through digital technologies and guide digital spend to best achieve those results. All digital initiatives are not created equally. Organizations must distinguish between digital business optimization, which seeks to improve the enterprise’s current business model, and digital business transformation, which seeks to push the enterprise beyond its current business model. A digital strategy must account for both digital business optimization and digital business transformation objectives.

Key Findings

• COVID-19 has increased the importance of creating and pursuing a digital strategy for how to use increased digital spend to achieve desired business outcomes. As the pandemic has forced rapid changes in many industries and behaviors, 70% of boards of directors expect to accelerate their digital business initiatives and strategies.

• Organizations pursue a combination of both transformation-oriented and optimization-oriented outcomes when shaping a digital strategy. In 2020, the average organization dedicated 37% of all digital spend on digital business optimization, 29% on digital business transformation and 35% on digital enablement that builds a technology foundation necessary to achieve the other two goals.

• Digital business optimization will form the core of most enterprises’ digital journeys. However, organizations or business units facing significant industry transformation or trying to be a first mover in a new technology will likely require a greater focus on digital business transformation.
Recommendations

To help their organizations set and act on their digital strategies, CFOs should:

• Track industry transformation and corporate risk appetite for digital leadership when helping the organization decide on an appropriate weighting of digital business optimization and digital business transformation.

• Tie digital business optimization efforts to key performance indicators (KPIs) that clearly track both digital progress and the expected business and financial outcomes. Set “balance points” that highlight the optimal level of digitalization and the expected increase in operational or financial performance.

• Highlight the highest-priority digital business transformation opportunities by prioritizing unit economics and operating margin considerations when assessing and deciding on different paths for digital business transformation.

• Commit to removing barriers to scale for digital business transformation funding by easing portfolio requirements around payback periods or profitability.
Digital Acceleration Requires Clearer Digital Strategies

COVID-19 has accelerated trends already in place, presenting a transition point for digitalization and digital investment. Sensing opportunities and disruption, seven out of 10 boards of directors are responding by accelerating their digital business initiatives and strategies. A survey of CIOs and IT leaders found that 51% increased investment and focus on digital business in 2020, while 36% maintained their previous levels despite widespread cuts to other spending areas.

In a shifting and volatile landscape marked by a widening economic profit gap between top performers and everyone else, getting digital spending right is crucial for future success. Gartner found that organizations accelerating digital business were more likely to see improved net profits, reduce operating costs and reach new customer segments. Given that boards expect a 6.9% increase in IT/technology budgets in response to COVID-19, CFOs need to understand how that spend connects to enterprisewide digital strategies and the business outcomes those strategies are pursuing. Ultimately, established companies will need to focus on both digital business transformation that seeks new revenue streams and business models and digital business optimization that apply new digital technologies to improve existing business models (see Figure 1).

Figure 1. Digital Strategy Framework
Digital Strategies Must Account for Both Digital Business Optimization and Digital Business Transformation

Unclear definitions and misunderstood terminology create costly misunderstandings when setting digital strategies and their connection to broader business outcomes. Before planning, level-set on what is being discussed. At the highest level, “digital” is the use of technologies to improve organizational processes and interactions or to make new business models possible. Depending on the context, digital may refer to a technology that represents physical items with code, such as how email is the digital embodiment of physical mail. It can also refer to the replacement of analog elements of practices or processes with digitized ones; for example, transitioning from traditional to more cost-effective digital marketing channels. Or it can refer to the dominant use of digital technologies and supportive practices to make a business model possible.

“Digital” is the representation of physical items or activities through binary code. When used as an adjective, it describes the dominant use of the latest digital technologies to improve organizational processes, improve interactions between people, organizations and things, or make new business models possible.

An organization’s digital ambition and strategy — the amount of digital change they would like to pursue and how they expect to accomplish it — can be broken down and described in terms of tangible outcomes being pursued. An organization will pursue both transformation-oriented and optimization-oriented outcomes through its digital strategy, with the key difference being the scope of change to existing business models. Digital optimization is the part of the digital strategy that improves existing operations and business models. This involves pursuing the same ways of creating value, but with a high degree of change in how the organization operates. For example, by digitalizing aspects of business capabilities or the organization’s profit model. Digital business transformation involves changes to business models and/or new product and service offerings. This requires a high degree of change in how the organization creates value, with a particular focus on pursuing new value propositions and customer bases.

Organizations pursue a combination of both digital business optimization and digital business transformation, though the exact right mix will vary. In 2020, the average organization dedicated 37% of all spend on digital initiatives to optimization, 29% to transformation and 35% to enablement that supports both goals by supporting IT platforms and other technologies that digital spend requires. Given that examples of wholesale enterprise business model change are rare, most organizations will only see true digital business transformation in smaller parts of the business at any given time based on where opportunities exist. More substantial nearer-term gains will come from digital optimization, which is less risky, by focusing on making current business models as digitally capable as possible. This then occasionally serves as a platform for later digital business transformation.
However, in times of transition, it may be necessary to dedicate more resources to bolder strategic moves. McKinsey found that top economic performers center their merger and acquisition (M&A) investments on digital opportunities and focus more on transformation, allocating digital capital equally between digitalizing the core business (optimization) and developing new digital businesses (transformation). At the very least, digital acceleration may necessitate growing the total size of the digital pie, even if the proportions remain the same. As of 2019, organizations allocated 31% of their total operating budgets to digital initiatives.

Although the CFO alone cannot declare an enterprise digital ambition, they play an important role in informing the weighting and linking the outcomes from digital business optimization and digital business transformation initiatives back to enterprise strategy and financial performance.

Digital Business Optimization Provides Nearer-Term Benefits

While digital business transformation often receives greater focus, digital business optimization can yield nearer-term benefits for the organization and provide a foundation for future transformation. Digital business optimization improves the performance of the organization’s existing business model. For many organizations, industry shifts are not apparent, and digital strategy can focus more on improving the existing business and laying a solid digital foundation for future transformation when shifts become more apparent. In pursuit of digital business optimization, an organization will seek a combination of the following business outcomes: increased revenue, improved operating margin, improved workforce, improved customer experience and increased asset utilization (see Figure 2).

Figure 2. Digital Business Optimization

![Digital Business Optimization Diagram]

Source: Gartner

SG&A = selling, general and administrative, RPA = robotic process automation

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CFOs can help their organizations decide on the right balance of outcomes to pursue from their digital business optimization initiatives and ensure that all digital spend contributes to those desired outcomes. During strategic planning meetings and discussions on strategic initiatives, keep the most important outcomes at the center of considerations. Using cost differentiation as a lens for evaluating digital initiatives can help identify the most important areas for digital improvement by highlighting initiatives that serve as points of differentiation. These points can include, for example, improving customer experience through novel channels that competitors cannot pursue or collecting and analyzing proprietary data to improve revenue or decrease sales costs.

**Set KPIs to Map the Ideal Level of Digitalization and Expected Benefits**

Because digital optimization initiatives strive to generate nearer-term returns with less risk than digital business transformation initiatives, CFOs should more aggressively pursue the expected revenue or cost-saving benefits that result from them. To monitor and decide if digital spend serves the desired business outcomes, set clear KPIs for each digital optimization initiative being pursued. Doing so and tracking them from the start helps to quantify digital goals and their expected benefits, highlighting the most worthy objectives to pursue and removing potential objections to digital initiatives.

KPIs should collectively answer how digital the organization currently is, what the digital optimization goals are, and which specific business and financial benefits will be realized once the digital goals are accomplished (see Figure 3). For example, initiatives digitalizing customer service can project the call center cost savings and lower expected times for issue resolution.

**Figure 3. Illustrative Digital Business Optimization KPI Framework**

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An important component when setting digital business optimization KPIs is to identify “balance points” that highlight the ideal level of digital optimization for any specific optimization goal. This point should determine the optimal level of digital optimization after which more digitalization becomes counterproductive for achieving the underlying desired business outcome. For example, when digitalizing customer service, the balance point is predicted based on customer satisfaction where a lack of analog, in-person service channels means that some customer problems are not adequately solved. Make sure that balance points are clearly tied to negative business and financial outcomes, and adjust these throughout your digital journey as new information becomes available.

Digital Business Transformation Pushes New Business Models

Digital business transformation pushes the enterprise beyond its current business model. What transformation will look like, and whether it is appropriate or not, will vary by organization and between business units. Consider skewing your digital ambition toward transformation if your industry has been particularly impacted by digital shifts resulting from COVID-19 or your organization desires to be a first mover on new technologies. In general, digital business transformation takes the form of launching net new, digitally enabled products and services or pursuing entirely new business models through metered, subscription-based or platform businesses. At the most extreme end, businesses can use digital business transformation to move into entirely new industries. Figure 4 highlights common types of digital business transformation and the resulting outcomes.

Figure 4. Digital Business Transformation

<table>
<thead>
<tr>
<th>Less Transformative</th>
<th>More Transformative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong> Sell Existing Digital Assets</td>
<td><strong>6</strong> Move Into Adjacent and New Industries</td>
</tr>
<tr>
<td>e.g., selling data, content and algorithms</td>
<td>e.g., Tesla Powerwall</td>
</tr>
<tr>
<td><strong>2</strong> Digitalize Product or Service</td>
<td><strong>5</strong> Run a Platform Business</td>
</tr>
<tr>
<td>e.g., selling connected machines and services</td>
<td>e.g., a business that has sellers and buyers all working on the same platform</td>
</tr>
<tr>
<td><strong>3</strong> Sell Metered Revenue</td>
<td><strong>4</strong> Contract Based on Shared Risk Outcome</td>
</tr>
<tr>
<td>e.g., selling on pay-as-you-use or subscription basis</td>
<td>e.g., price varies based on a shared outcome metric</td>
</tr>
<tr>
<td>Connected Revenue</td>
<td>Platform Revenue</td>
</tr>
<tr>
<td>New Industry Revenue</td>
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The business outcome of focus for all digital business transformation initiatives is to create new sources of revenue. This could be connected revenue based on selling digital assets, digitalizing products or services, or selling metered revenue. It could also be platform revenue from running a platform business or new industry revenue. CFOs can help promote digital transformation initiatives that support the strongest future revenue growth and highlight which of the above transformation options are best for creating revenue.

**Focus on Unit Economics and Scale for Digital Transformation Initiatives**

The challenge for organizations and CFOs is to ensure that organizations realize the benefits of their digital business transformation initiatives. To help better realize digital business transformation outcomes, organizations can take lessons from digital natives who have built their digital business products and models from the ground up.

First, CFOs should focus on customer economics and operating leverage when assessing transformation opportunities in new digital product areas or forms of business models. Ask how digital business transformation helps decrease customer acquisition costs or increase customer lifetime value. For a new business model or product to be viable, its customer lifetime value must be higher than its customer acquisition cost. Digital business transformation may result in ecosystems that are mutually reinforcing and lower customer acquisition costs for other digital products or services. CFOs should consider ecosystem effects when assessing different options for digital transformation.

Successful digital business transformation initiatives are also characterized by larger operating margins, where the incremental cost to produce a product or service is much lower than the incremental revenue it generates. Operating leverage drives eventual margin improvements for organizations and improves unit economics at scale. CFOs can improve the revenue outcomes for digital transformation initiatives by reinvesting any cost savings the organization generates into technologies that improve operating leverage.

To achieve the expected revenue growth from digital business transformation, CFOs must remove barriers to scale, one of the largest being access to funding. An EY survey found that access to capital for digital transformation has been most challenging when the CFO was primarily responsible for digital capital allocation. While it is important to ensure that digital business transformation initiatives meet operational and financial targets, funding should be linked first to revenue growth and market share. Again, a lesson from the most successful digital-native companies is to put growth in revenue and customers above profits until scale is achieved. Easing barriers around payback periods or profitability can help ensure funding that digital business transformation efforts require to reach the scale necessary to be successful. Committing upfront to fully funding digital transformation initiatives may help overcome some skepticism from other executives.
Collaborate With Executive Team to Set Digital Ambition

As a first step in shaping a digital strategy, CFOs should partner with their IT peers and executive teams—particularly with the CEO, CIO and CTO or CDO where applicable—to set the organization’s digital ambition and strategy. Doing so requires agreement on the right level of transformation-oriented and optimization-oriented outcomes to pursue. While the balance for most organizations will skew toward digital business optimization, CFOs should not discount the possibility that some amount of digital business transformation may be necessary for long-term value creation. Although there are risks from moving too fast on digital business transformation and getting out ahead of customers, moving too slow costs organizations the value and expanded market share new opportunities present.

Different leaders naturally have different preferences for the balance between digital optimization and transformation. While CEOs may prefer slightly more transformation, CIOs are likely to be more concerned with implementation and favor the certainty optimization provides. Tying discussions to the stage of industry transformation and the organization’s natural digital ambition or risk appetite will help build agreement on the correct balance between optimization and transformation. Industry transformation can be modeled as an S-curve, with digital transformation coming at the apex (see Figure 5). During a stable growth period along the rising slope of the S-curve, it may make more sense to focus on optimization and transition toward transformation when approaching the S-curve’s apex.

Figure 5. Set Digital Journey in Relation to Inflection Point

Source: Gartner
Gartner research suggests leaders track inflection points emerging from new technologies, shifting culture or new regulations to help predict the cadence and scope of transformation for their industries. Level-setting on where along the curve the organization currently is makes it easier for leaders to make decisions. Once you level-set, you can skew digital ambition and funding toward either transformation or optimization relative to the organization’s current state — or baseline if starting your digital journey from scratch. The ideal baseline is likely to be a function of the organization’s competitive stance or culture around being early technology adopters. About one-third of CEOs want to be pioneers and push an early adoption stance for their enterprise. For these organizations, digital ambition, regardless of the stage of industry transformation, will shift more toward business transformation than optimization. Once a balance between the two is decided, monitor the digital portfolio to ensure that it promotes the right level of optimization and transformation.

When discussing digital strategies and ambitions, executive teams often suffer from pitfalls such as siloed thinking, shortsighted analyses and a static perspective of the industry and digital priorities. The net result is an unclear digital strategy disconnected from the business outcomes the organization is trying to pursue. CFOs can focus discussions on the most important business outcomes and expected financial returns that should inform the digital ambition. These discussions can center around the creation of a digital business strategy and roadmap where leaders will plan out digital business optimization and transformation focuses and outcomes up to a certain planning horizon.

No organization should pursue all digital business optimization and transformation outcomes at the same time. Not every outcome is equally important for an organization at all times, and a careful prioritization can help focus attention and resources where they will be most effective. During strategic planning, strive to select a limited number (two to four) of the digital business optimization and digital business transformation outcomes highlighted above as critical to achieving your organization’s digital ambition. Narrowing the focus can help better execute your digital strategy. For example, a consumer goods company may focus primarily on digitalization products and services and then enhancing customer experience and reducing selling, general and administrative (SG&A) costs through new digital technologies. Once this ambition is decided, it sets the foundation for the digital business strategy for how to achieve it. CFOs can reevaluate how their own practices promote or hinder progress against it.
Conclusion

As COVID-19 accelerates digital transformation for many organizations and industries, CFOs should play a role in setting their organization’s digital ambition and strategy and ensuring that their organizations investments and capital decisions support it. Understanding the difference between digital business optimization and digital business transformation outcomes allows CFOs to support the efficiency gains, revenue growth and other business outcomes that motivate their organizations to digitalize in the first place. They can do so through a greater focus on unit economics and scale for transformation and clear KPIs that track digital optimization goals and outcomes. Work with your organization to clarify your digital ambition and the outcomes you should be seeing as a result.

Endnotes

1 2021 Gartner Board of Directors Survey
2 2020 Gartner Digital Business Acceleration Survey
3 2020 Gartner Business Cost Optimization Through a Crisis Survey
5 2019 Gartner Digital Business Survey
6 Will Your Digital Investment Strategy Go From Virtual to Reality? EY.
7 2020 Gartner CEO and Senior Business Executive Survey
Actionable, objective insight

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