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Time for CFOs to step up

As investors home in on business fundamentals and credible accounting, the CFO's traditional role overseeing planning and performance takes on new urgency.

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The chief financial officer's job has become more complex in recent years as mergers and acquisitions, financial structuring, and managing relations with investors and analysts have demanded increasing time and attention. At the same time, the potential value that the CFO adds in a more traditional role—as guardian and leader of good planning and performance management—has lapsed into neglect. Today, as business fundamentals and credible accounting become the new touchstones by which investors judge corporate quality, many companies would benefit from renewed attention by the CFO to helping the CEO understand the performance of the company's businesses and evaluating critical strategic decisions.

No question, mergers, financial dealings, and investor relations are important. Mergers can add significant value under the right circumstances, as can innovative financing. Good communications with investors and analysts can avoid unnecessary market volatility and ensure companies get credit for strategies they pursue. But for most companies, shareholder value comes from internally generated growth, through new products or services, new businesses or through cost/capital efficiences.

It is a characteristic of today's business climate that a seemingly endless stream of advice exists about shortcuts that promise to create value without much hard work. In just the past few years executives have been exposed to VBM (Value Based Management), EVA® (Economic Value Added, also known as economic profit), Balanced Scorecard, CFROI (Cash Flow Return on Investment), and a flurry of other performance measures. More recently, intangibles like brand and knowledge have captured attention. Most of these ideas are good and largely common sense, but none are perfect. And certainly none of them contain a magic bullet that would make improving performance easy.

Instead, the hard work of designing and implementing a successful planning and performance management approach is about developing a method that works for your company. Even the most sophisticated financial measures that aren't adapted to your situation will fail; a less sophisticated approach can create significant value if it is tailored to your industry and your needs.

With that in mind, here are four principles that CFOs can rely on to keep themselves—and their companies—on track.

1. Understand how your company creates value. It is surprising how many executives don't know exactly how their business units create value. In our research we found that half the retailers in the United States don't earn their cost of capital. Yet managers at many of these companies demonstrate an obsession with growth that will destroy value until they can figure out how to improve their returns on capital. In the pharmaceutical industry, for example, where the leading companies typically earn after-tax returns on capital in excess of 30 percent, growth has a much larger value impact than increasing returns. Yet many pharmaceutical companies don't effectively measure or manage the value of their research, development, and product launch activities. This process need not be overly complex, but it must give management transparency on cash flow, risk, and returns on capital invested.

In the absence of authoritative planning leadership, it is easy for executives to focus on the wrong value-creation measures. At one company, top managers agreed to vote on performance measures. Product innovation was popular with the management team. Analysis of how the company really created value, however, demonstrated that product innovation was not nearly as important as customer service and process management. Focusing on product innovation was distracting top management from real opportunities to create value. The bottom line: understanding how your company creates value isn't conceptually difficult, but it does require a disciplined approach.

2. Integrate financial and operational measures. Most planning and performance management systems are based entirely on short-term financial measures. Even a sophisticated financial measure like economic profit, which measures the return a company earns over its cost of capital, tells only where a company has been—not where it is going. Nor do most systems identify the value drivers behind financial performance. These value drivers need to be easily conveyed to line management, and also need to be periodically reviewed and updated. Shorter term metrics like economic profit should be used in conjunction with indicators of longer term performance, like market share, to avoid decisions that may improve value temporarily but destroy it in the long run.

The story of one leading consumer packaged goods company illustrates the flaw of focusing purely on financial measures. One of this company's most successful business units reported substantial operating profit growth year after year, consistently meeting or beating targets. As long as the unit appeared to be doing well, senior management did not question the unit's performance. Only later was it revealed that the way the unit achieved its profit growth was by raising prices. In itself, this would not be a bad move, but over several years the effect of the price increases was to create an umbrella for competitors to take market share. Declines in market share eventually reached the point where operating profit growth could not be sustained. The crisis that resulted led financial markets to lose confidence, forcing a major reorganization.

For the CFO, creating the best performance measurement systems entails seamlessly integrating financial and nonfinancial measures. With such a system in place, management can understand what drives financial results and provides access to leading indicators that help managers understand where the business is going.

3. Keep the measurement system transparent and uniform. Performance measurement systems can take on a life of their own. One company created a corporate staff of dozens to accurately calculate sophisticated financial measures. Predictably, the business units didn't believe, understand, or use them to run their businesses—largely because they were not involved in developing or adapting the measures. At another company, the calculations were so complex that business unit managers didn't understand how their decisions would affect their results.

Another common problem stems from implementing parallel or even competing measures. Typically, only one measure is taken seriously, while others get lost in the system. One company prominently introduced economic profit as a new performance measure, but only as a supplement to traditional income statement and balance sheet metrics. As such, it had no official standing in planning and reporting sessions and never made its way into the compensation system. Despite all the effort, the new measure was ignored.

Measuring financial performance is an imprecise discipline, but any system should focus on the true drivers of growth and return on investment. Companies should start with a simple, directionally correct measurement driven off standard financial statements as those are typically more useful than complex, theoretically correct systems. Furthermore, companies should use one system and language for budgeting, performance measurement, capital budgeting, and incentive compensation to avoid sending conflicting signals to managers.

4. Focus on the dialogue. The real purpose of planning and performance management is to help a company make better strategic and operational decisions. The best decisions are based on superior understanding of the business, which comes from an effective dialogue within the management team or between business unit managers and corporate managers.

The best numbers will not replace judgment, nor should they. But they will help managers understand the overall business, and help senior managers better understand the business units they oversee. They will help managers negotiate aspirational but realistic targets. And they will help them understand why business units meet or do not meet performance targets and what should be done.

The CFO is the guardian and the leader of good planning and performance management; he or she must not lose sight of the control dimension that the CFO role has traditionally held. By going back to basics, CFOs can bring to bear the capability, people, processes and systems to deliver on the principles outlined above and they can more effectively answer the critical questions investors are asking today about fundamental performance. The process may be less exciting than M&A and some other higher profile elements of the CFO job, but it is the bedrock through which value creation is managed. MoF

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