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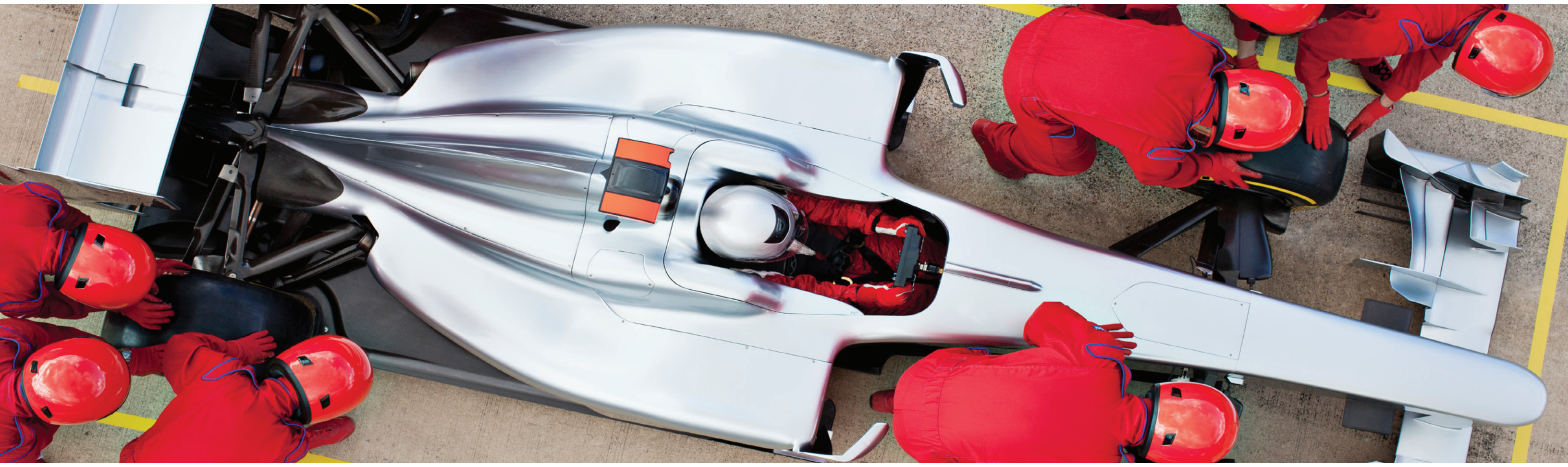

Corporate Finance

Why CFOs need a bigger role in business transformations

CFO involvement can lead to better outcomes for organization-wide performance improvements.

Ryan Davies and Douglas Huey

When managers decide that a step change in performance is desirable and achievable, they'll often undertake a business transformation. Such transformations are large-scale efforts that run the full span of a company, challenging the fundamentals of every organizational layer. That includes the most basic processes in everything from R&D, purchasing, and production, to sales, marketing, and HR. And the effect on earnings can be substantial—as much as 25 percent or more.[1]

Given the degree of change such endeavors require, this would seem to be an ideal opportunity for CFOs to play a major role. They are, after all, already familiar with the many activities and initiatives that underlie a transformation. And they often have an organization-wide credibility for measuring value creation. The way it usually works, though, is that CEOs sponsor transformations. A full-time executive—often a chief transformation officer—assumes operational control, and individual business units take the lead on their own performance. That often leaves CFOs on the sidelines, providing transaction support and auditing the transformation's results.

This is unfortunate. In our experience, without the CFO's leadership certain key elements of the transformation are likely to receive short shrift: performance efforts will lack a meaningful benchmark to gauge success, managers will be tempted to focus on the biggest or most visible projects instead of those that promise the highest value, and expected transformation benefits won't make it to the bottom line. That is why when transformations are planned, it's important that CFOs step up to play a broader role, one that includes modeling of desired mind-sets and behaviors in transforming the finance function itself.

Establishing a clear financial baseline

The value of a transformation is only measurable relative to a meaningful baseline, a natural part of the process for the finance function to manage. An effort that improves a company's earnings by $200 million might appear successful, if you didn't know that the market grew at the same rate. Similarly, a transformation where earnings fell by 5 percent might seem to have failed, if you didn't know that earnings would have fallen by 20 percent without the effort. And performance can be affected by any number of events and activities unrelated to a transformation under way, such as M&A, openings or closures of plants, fluctuations of commodity prices, and even unplanned business disruptions or large restructuring charges. It sounds like a simple dynamic, but it's often misunderstood and poorly communicated.

Many companies simply use last year's reported financials as a simple baseline. That's preferable to using forecasts or budgets, which can include suspect assumptions, but a meaningful baseline is usually more complicated. Last year's performance might reflect one-time adjustments or may not accurately reflect the momentum of the business—which is the true baseline of performance. And next year's performance could depend, instead, on industry-wide trends. For example, for an equipment manufacturer in an industry facing rapid price declines, the prior year's performance wouldn't work as a baseline for setting transformation goals. Instead, managers would need a baseline that reflects forecasts for how much prices would deteriorate, both overall and by region.

This is a natural part of the process for the finance function to own, since baselines are necessary for valuing both individual initiatives and overall transformation performance. That said, there is no cookie-cutter formula that applies to every company—and adjusting a baseline often involves a lot of moving parts. In one manufacturing company, for example, managers had to set a baseline that reflected changes in commodity prices, an expected decline in sales volume and prices in one market, and the effects of additional plants and facilities in another. CFOs must ultimately use their technical skills and judgment to define which assumptions to include in their projections of how a business is likely to perform in the absence of a major transformation. That, then, becomes the baseline against which the company measures its success—and how it communicates that performance internally and to investors.

Clarifying which initiatives create value

Given the volume of initiatives and limited time and resources available in a transformation, managers often find it challenging to set priorities for the ones that promise the most impact. We've often seen good ideas languish because they were undervalued while managers directed resources to overvalued initiatives instead.

Take, for example, the experience of managers at one consumer-retail company. They were convinced that the company's lagging performance was due to a year-on-year decline in sales and promoted an effort to boost them. Increasing sales would have been good, certainly, but product margins were so low that improving sales could add little to the bottom line. Meanwhile, managers had overlooked a dramatic increase in operating costs. Cutting them offered a much richer target for bottom-line improvement. The finance function was better equipped to provide such analysis and focus management on this bigger opportunity.

Valuing such initiatives often requires nuanced thinking. Although some transformations include radical changes, most create significant improvements on the margin of existing operations. That requires an understanding of the organization's marginal economics—that is, the costs and benefits of producing one additional unit of product or service. When managers have a clear understanding of the marginal value of improving each of the activities that contribute to performance, they have the potential to redirect an entire transformation. For example, when the CFO at a natural-resource company examined the value of marginal production, he found it to be much less than front-line managers expected. Finance analysis revealed that swings in commodity prices had changed the relationship between variable costs, fixed costs, and revenue, with profound implications for trade-offs and decision making on-site. Guided by this insight, the CFO's coaching helped the company shift its transformation priorities from increasing production at a less-profitable location to creating operating flexibility that supported more profitable areas of the business. While this part of the value chain would itself generate lower profits, managers understood that the company overall would benefit.

At many companies, an emphasis on accounting profits can lead managers to focus on actions that drive annual or quarterly earnings even when they have a negative effect on cash flow. A high-pressure transformation environment, where managers are suddenly held accountable for delivering stretch targets, can exacerbate this tendency. Finance forms an important line of defense. CFOs can verify that improvement initiatives aren't simply cutting investments in tomorrow's performance in order to boost today's numbers. They can also check for noncash improvements that show up on the profit and loss (P&L) statement but don't actually create value. Conversely, they can highlight cash improvements, such as reducing working capital, that add real value but don't affect the P&L.

One cautionary note: identifying initiatives that create the most value doesn't mean differentiating their valuations down to the last dollar. Transformations need to be fast-paced, with a bias for getting things done, because the time lost to overanalysis often represents lost value to the business.

Ensuring that benefits fall to the bottom line

All too often, turnaround initiatives that could create great value never get to a company's bottom line. Sometimes, the problem is just poor exe-

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cution. At one mining company, for example, an initiative owner successfully negotiated lower rates on rental equipment with a new vendor, but then neglected to return the incumbent vendor's equipment. Fortunately, the finance function discovered the duplicate rentals in its detailed reporting of monthly cost performance, and the company was able to quickly return the equipment before accruing further costs.

But often the problem is a lack of visibility into what's expected and too little coordination between units or functions. As a result, the savings accrued in one part of the business are offset by expenses in another. At one manufacturing company, for example, procurement managers successfully negotiated savings on a contractor's hourly rate. But since the overall plant budget wasn't adjusted, the plant manager ended up just using more hours on discretionary projects, and the overall contractor cost did not decrease. Managers at another manufacturing company managed to reduce production costs but neglected to update the margin targets for the sales department. As a result, some sales managers lowered their minimum price to maintain their margin—effectively giving away the savings in the form of sales incentives and lower prices.

Finance specialists can help by reviewing how a company reports progress and ensuring that objectives are clear organization-wide. This can include, for example, ensuring that transformation priorities are translated into formal budget commitments. It also includes translating traditional P&L accounts, such as cost of goods sold and overheads, into the underlying measures that affect their value, such as volume, foreign exchange rates, head count, and productivity. That offers managers a much clearer understanding of how value is created (exhibit).

Creating insightful management reporting for companies with integrated value chains can be especially challenging. Since performance across such businesses isn't readily apparent from their consolidated accounting statements, it's all the more difficult to understand whether a transformation is effective. To help, the CFO at one metals company completely changed the reporting structure, disaggregating the business into multiple enterprises, each with its own CEO and P&L, based on transfer pricing between enterprises. The company continued to produce consolidated reports for external stakeholders. But the CFO used internal reports to help the various parts of the organization understand how they created value, enabling them to identify more opportunities to turn a profit.

Leading by example

Helping managers clarify the value of initiatives is just the start of the CFO's and finance function's contribution. Just as important is how the finance function performs internally. A finance function that innovates and stretches toward the same level of aspirational goals as the rest of the organization adds to its credibility and influence.

Leading by example is partly about modeling desired behavior. By taking a pragmatic view of the level of detail and rigor needed to make good decisions in the finance function itself, the CFO can set an example of good behavior for the rest of the company. For example, at one refinery operation, the CFO role-modeled a bias for action by drastically simplifying the valuation assumptions for initiatives. That enabled the operation's leaders to focus on execution. Even though the value of these initiatives was potentially overstated by 10 to 20 percent, it was clear the leaders were focused on the right improvement areas.

But leading in this way is also about reducing costs while increasing efficiency and effectiveness.[2] Initiatives that streamline activities and cut costs inside finance also radiate throughout the

Exhibit

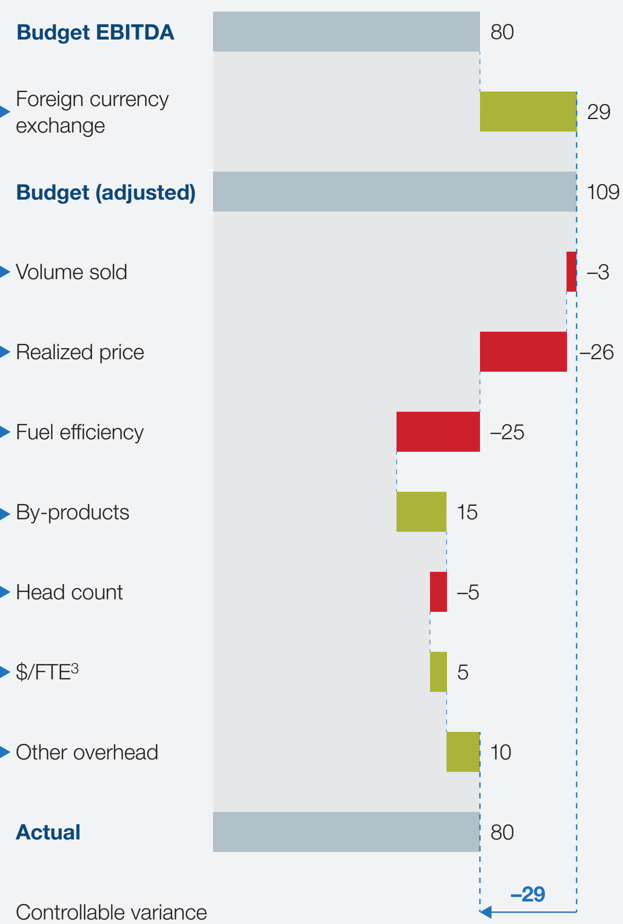
Reporting business performance against the measures that affect value clarifies what really matters with respect to cash flow.

$ million

Business results are generally structured in accounting terms to explain *what* happened

	Budget	Actual	Variance
Sales	250	243	–7
COGS[1]	–150	–168	–18
Gross margin	**100**	**75**	**–25**
By-products margin	20	35	15
Overhead	–40	–30	10
EBITDA[2]	**80**	**80**	**0**

Reporting against the underlying measures that affect value explains *how* the results happened



[1] Cost of goods sold.
[2] Earnings before interest, taxes, depreciation, and amortization.
[3] Full-time equivalent.

organization. Simplifying processes, making access to accounting systems easier, and eliminating layers of approval or redundant reports also eliminates waste elsewhere. The experience of one financial company is typical. After reviewing its accounting-journal entries, the finance function concluded that more than half the processes were unnecessary and introduced new guidelines to reduce the workload. The CFO also discovered that managers were using two different reports to assess the performance of what was essentially a single business unit. Not only did different layers of the organization have a different view on how to measure performance, but certain business units were also using entirely different reports to explain their results and manage their activities. After leading a healthy debate on how to define a consistent view of assessing performance, the CFO set up a common and cohesive approach for the entire organization, cutting reporting activity by 40 percent in the process.

Finally, stronger financial controls inside the function can help quickly reduce costs organization-wide, particularly where cash is short. Finance might, for example, lower the threshold at which purchases require approval, cancel company credit cards, or even close open purchase orders. Such moves can be unpopular, and managers can spend weeks, if not months, debating whether they'll improve performance or hurt productivity and employee morale. But how successful they are often comes down to the ability and conviction of leaders to strike a balance between control and empowerment. The finance function is well placed to address organizational resistance, given its practical knowledge of financial systems and controls. It can also provide a credible independent perspective in setting an appropriate level of control.

CFOs and the finance function can help companies successfully deliver on the full potential of a transformation. To do so, they must be judicious about which activities truly add value and embrace their roles in leading the improvement in both performance and organizational health.

[1] Michael Bucy, Stephen Hall, and Doug Yakola. "Transformation with a capital T," *McKinsey Quarterly*, November 2016, McKinsey.com.

[2] Richard Dobbs, Herbert Pohl, and Florian Wolff, "Toward a leaner finance department," April 2006, McKinsey.com.

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