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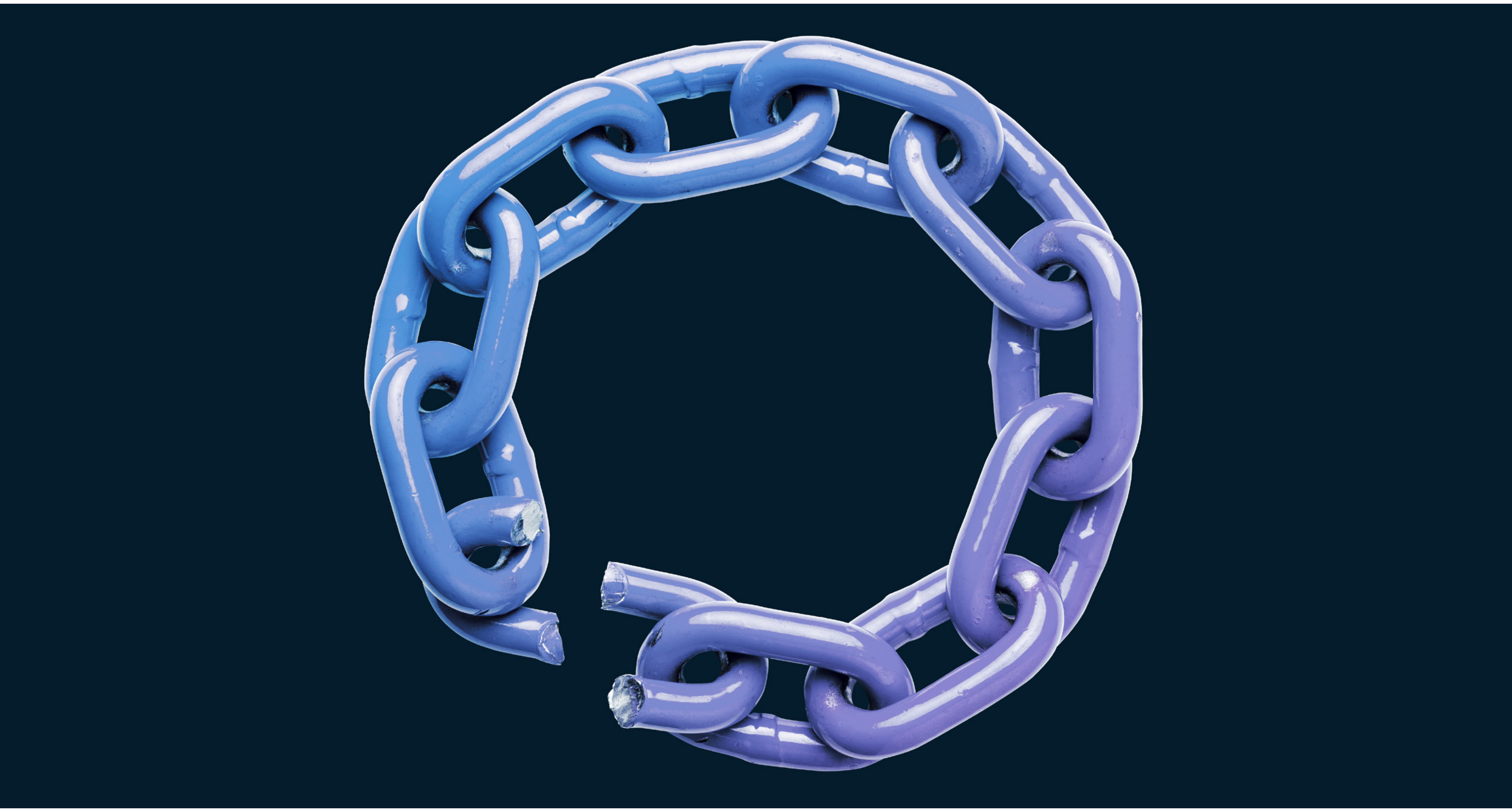
Why isn't your transformation showing up in the bottom line?

The success rates of large change programs vary widely. Finance teams can make a big difference in the outcome of these initiatives by articulating and validating the link between transformation efforts and long-term value.

by Ryan Davies, Douglas Huey, and David Kennedy



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"Transformation" is the buzzword of the day for companies in most industries, but for many it carries an asterisk: studies show wide variation in companies' rates of success with organizational transformations—whether they are changing how they go to market, updating back-office processes, automating production systems, or otherwise making significant changes in how their businesses are structured and run.

In some cases, this variation exists because executives propose fundamental changes in how the business operates but don't go through the hard process of setting commensurate performance targets. They often set targets too low, aiming for incremental change. When they do set their sights appropriately high, they often fail to adequately make clear to key stakeholders who owns the goals and responsibilities associated with various elements of the transformation. As a result, value can end up "leaking" even from good initiatives, which can sap companies' efforts to meet bottom-line targets, drain momentum from good investments, and impede buy-in for change efforts generally.

CFOs and finance teams have a critical role to play in not only setting ambitious targets but also providing the discipline to mitigate value leakage and fully deliver transformational benefits to the bottom line.

Given the steep learning curve involved with transformational change, it is typical for companies to realize some leakage in value early on. Transformation initiatives may underdeliver because of inaccurate assumptions going into the project or suboptimal execution of the project. In other instances, initiatives may deliver benefits as intended, but managerial actions in other parts of the company create leaks—for instance, when cost savings are passed on to customers through higher discounting than necessary. Sometimes macroeconomic effects outside of management's control—currency fluctuation, for instance, or a change in the cost of production inputs—end up offsetting genuine benefits from transformation. Separately, savings realized through transformation may be deliberately reinvested in growth—which, in itself, can be a wise decision—but a lack of transparency about this process can create confusion about bottom-line impact, as well as misperceptions about the success or failure of the transformation (exhibit).

To keep large transformations on track toward finance goals, CFOs and finance teams must help business-unit leaders and the CEO articulate and validate the value to be gained from the initiative, as well as the scope of change required. Once initiatives are under way, the finance team should provide "single stream" forecasts, business

Exhibit

There are four reasons why the full benefits of transformation may not show up in the bottom line.

		Challenge	Example
Sources of leakage	Initiative underdelivery	Change initiatives deliver fewer benefits than forecasted	A new product takes longer to launch than planned
	Underperformance elsewhere in the company	Management's actions erode value, independent from or despite outcome of change initiatives	Savings from a change initiative are passed on to customers through greater discounts
	Exogenous headwinds	Factors outside the company's control affect performance	There are currency fluctuations, or market-wide inflation of the cost of raw materials or labor
	Reinvestment	Lack of transparency about reinvestments creates confusion about bottom-line impact	There is increased spending on R&D, sales, or marketing

reports, and budgets—combining data about transformation activities with those for daily operations. In this way, the CEO and business-unit leaders can more easily identify which aspects of the transformation are working in which areas of the business, which initiatives might be introduced in other parts of the organization, and which should be revamped or abandoned entirely.

Over time, the CFO and finance team can also help companies sustain their transformation efforts by continually monitoring and identifying the root causes of value leakage and performance issues so teams can better address them. Business leaders will likely be better prepared to address the most common earnings-call question when it comes to change initiatives: "Are they showing up in the bottom line?"

Big goals, detailed plans

Time and time again, we've seen that the companies that have found success with their transformations relative to peers have established the overarching purpose of change initiatives at the outset, often relying on one of three major objectives: pursuing growth, pursuing operational improvements, or reallocating portfolios. They jettison status quo approaches to planning, in which budget conversations and other discussions are grounded primarily in "what we did last year."[1] Instead they set internal and external commitments that are aspirational.

The CFO and finance team are well positioned to put teeth into the CEO's big, hairy, audacious transformation goals. They have the data and cross-functional perspective to coach teams on how to assess the value of proposed transformation initiatives and what the financial and operational milestones should be. They can also ensure that business-unit leaders and frontline managers have detailed plans for hitting all those targets.

Indeed, the finance team must set the ground rules: in too many companies, executives—in their haste to launch a new idea—often forgo a formal evaluation of the business case by the finance group, relying instead on their own back-of-the-envelope calculations and risk assessments, turning to finance leaders only when issues crop up. But, with support from senior management, the CFO can mandate the finance team's review and approval of a detailed business plan before any transformation initiative launches.

That business plan should, of course, include key performance indicators (KPIs) that show a clear connection between operational changes and financial outcomes. A large retail company, for instance, wanted to reduce levels of inventory without negatively affecting customers' purchasing experiences. The finance team and supply-chain leaders jointly conducted a review of inventory to identify fast- and slow-moving SKUs, as well as the balance of inventory being held at distribution centers and stores at any given time. With this information in hand, they updated the operational targets—the amount of inventory on hand, stock-out rates, and so on—needed to create the financial outcomes desired. Business leaders then instituted new rules that empowered supply-chain leaders to reposition inventory as needed to ensure that customers could still find the items they wanted, when they wanted. The systematic review of KPIs made financial and operational objectives clear to all, and it encouraged supply-chain and frontline managers alike to commit to the transformation approach.

Integrated forecasts, reporting, and budgeting

Business leaders often separate transformation efforts from day-to-day operations—giving project managers and teams the time and space to pursue pilot initiatives and insulating them from the rest of the business. In doing so, they are missing a huge opportunity: by involving more employees earlier, the company can create buy-in for transformation across the organization.

The same holds true for integrated business forecasting, reporting, and budgeting: a regular review

[1] Tim Koller, Dan Lovallo, Olivier Sibony, "Bias Busters: Being objective about budgets," September 2018, McKinsey.com.

A regular review of transformation-related data alongside run-the-business numbers can give stakeholders the insights they need to actively engage in and commit to a change program.

of transformation-related data alongside run-the-business numbers can give business-unit leaders, employees, and other key stakeholders the insights they need to actively engage in and commit to a change program. A big-picture, single-stream view can reveal the scope of investments the company is making, the impact of those investments for the overall organization, and how the company is meeting or exceeding budget numbers.

Forecasting. Once they've reviewed and approved transformation initiatives and business plans, CFOs and their forecasting, planning, and analysis (FP&A) teams will need to reconcile business plans with existing forecasts and clarify the potential value from transformation. The CFO will likely assign members of the FP&A team to clarify underlying assumptions and then revise forecasts and communicate them to senior management as well as the business-unit leaders. In this way, everyone will understand the degree to which the bar for performance has changed. For instance, if a business unit with $1 billion in revenue expects $50 million in top-line losses because of pricing pressures but has committed to create $100 million in transformation benefits, everyone should expect the business unit to deliver $1.05 billion in revenue (accounting for the erosion).

Business reporting. Integrated business reporting can help the CEO and business-unit leaders clearly track the relationship between financial and operational activities and outcomes—which is critical, because the success of transformation activities can't always be judged solely through financial metrics. Consider a company that has decided to simplify its product design to reduce manufacturing costs. In the midst of this transformation, teams report that cost per unit is down and throughput rates are up, but quality has dipped slightly. A purely financial view would focus only on the direct cost per unit—a misleading figure, in this case. An integrated report, comparing current KPIs against baselines established during initial planning, as well as the targets established initially for throughput and quality, would provide a more comprehensive perspective on the net benefit of this initiative.

Budgeting. The budget process is where CFOs and their teams can lean in and ensure that the value being captured from transformations is retained and that previous financial and operational commitments are preserved. A key challenge for them is getting the first year of the transformation in sync with the overall budget cycle. It is rare for executives to restate a budget to account for the new commitments associated with transformation; instead they tend to rely on updated forecasting. But in the second year, CFOs will have more data in hand, and therefore more opportunity to lock in transformation benefits—clearly stating the costs of transformation (one-time and recurring), the recurring benefits, the incremental benefits from partially realized initiatives, and the outstanding commitments to the transformation. The owners of the transformation project should be able to help the finance team to streamline aspects of the budget cycle, as they can supply much of the required data.

No question, enhancing existing forecasting, reporting, and budgeting processes and establishing an integrated view will require an extra measure of time and resources from the finance team, but it is critical for improving the outcomes of transformation initiatives as well as the overall health of the organization. In all three phases, it is important that finance and business leaders use prior-period actuals when comparing performance figures and assessing the impact of the transformation. Using prior-period actuals can help teams correct for the clutter sometimes associated with companies' budgeting exercises and get a clearer sense of performance against targets.

Translating insights into action

Establishing ambitious goals, detailed plans, and comprehensive reporting is important. But just completing those tasks won't automatically change everything; the company's leaders must then be able to turn insights into action. To do so, they need strong, ongoing support from the finance team to systematically identify sources of value leakage, make course corrections, monitor progress, and inform subsequent discussions about the company's transformation initiatives. With this level of collaboration, transformation becomes part of regular management discussions—and CFOs and finance professionals remain central participants in the dialogue.

Specifically, finance teams need to help guide their business partners' focus and decision making. Rather than overload business leaders with as much data as possible, finance teams should seek to simplify—for instance, presenting conclusions from their analyses, using the data only to support any insights, options, and recommendations, and making sure to tie their findings to specific performance issues or emerging opportunities associated with the transformation. The finance team at one retail company has established a standard one-page template for summarizing proposed options relating to transformation initiatives, as well as decision logs, so that transformation decisions are framed and discussed in a consistent manner, at all levels of the organization.

The most effective change programs allow companies to perform much better than peers and create outsize value for their shareholders, doing both over an extended period of time. But long-term success with transformations is hard to achieve unless executives set ambitious goals and then work with the business and the finance function to ensure that those intentions show up directly in the company's net financial performance.

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