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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 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-

Although some transformations include radical changes, most create significant improvements on the margin of existing operations.

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 organization. Simplifying processes, making access

Exhibit

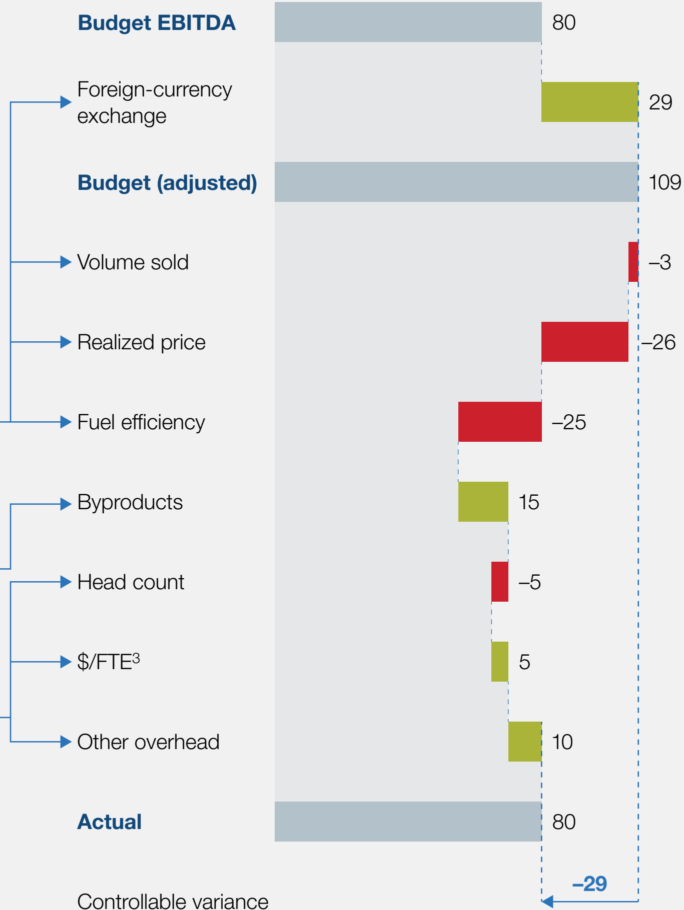
Reporting business performance against the measures that affect value clarifies what really matters with respect to cash flow.

$ 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.

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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Are today’s CFOs ready for tomorrow’s demands on finance?

Survey results show that as their role expands to include ever more nonfinancial demands, CFOs know they must build new skills to lead.

Faced with advances in technology and growing responsibilities, many CFOs are bracing themselves for more change ahead—and understand that they must adapt to be effective. In the latest McKinsey Global Survey on the role of the CFO,[1] finance leaders report that there are new demands on their time, such as digitizing critical business activities and managing cybersecurity, in addition to traditional finance duties. While these newer responsibilities present opportunities for finance leaders to differentiate themselves—and their companies—from competitors, many CFOs believe their companies are not yet prepared to manage these challenges.

Most CFOs know it’s no longer enough to play their traditional role. Instead, for CFOs to deliver value as their duties evolve, the results suggest that they must build skills in other areas of the business, play a more active leadership role, and rethink their usual approaches to overcoming external pressures and finding new investment opportunities.

Jean-François Martin

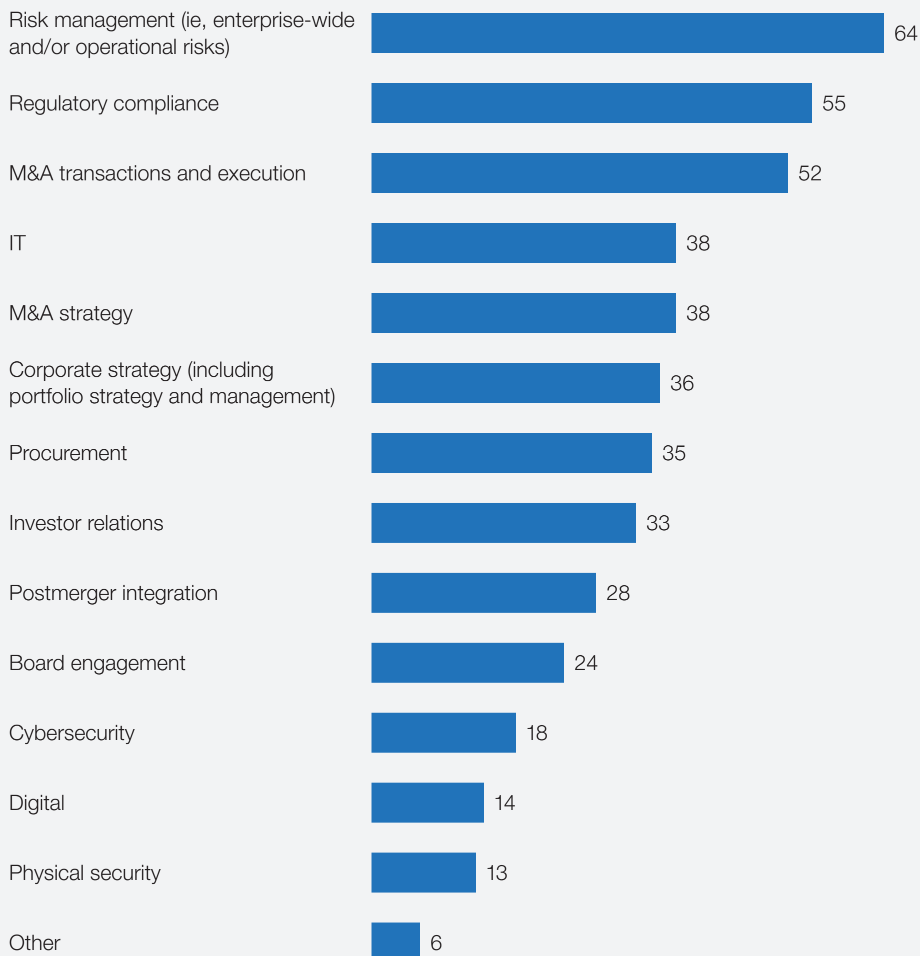
The CFO’s growing mandate

Today’s CFOs are responsible for much more than finance. On average, five functions other than finance now report to the CFO (Exhibit 1). More than half of CFOs say their companies’ risk, regulatory compliance, and M&A transactions and execution report directly to them, and 38 percent of CFOs are responsible for IT. Some CFOs even manage cybersecurity and digitization, suggesting just how diversified the list of demands on the CFO is.

Exhibit 1 **Many functions other than finance now report to the CFO.**

% of CFOs,[1] n = 193

Activities or functional areas that currently report to CFOs



Average number of activities/ areas: 4.53

[1] Respondents who answered “don’t know” are not shown.

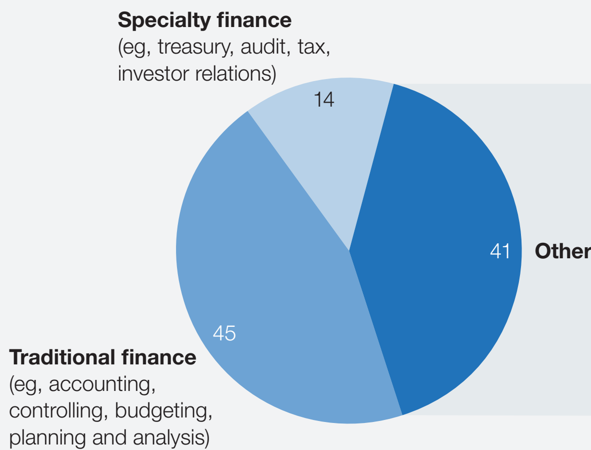
For the most part, CFOs understand that their roles continue to change and expect to adjust their course. About four in ten CFOs say they spent the majority of their time in the past year on roles besides traditional and specialty finance. Among these other roles, CFOs most often focused on strategic leadership, organizational transformation, and performance management (Exhibit 2).

Exhibit 2

Last year, four in ten CFOs spent most of their time on strategy, transformations, or another nonfinance area.

% of CFOs[1]

Roles where CFOs spent the most time, past 12 months



Areas where CFOs focused on nonfinance roles spent the most time, past 12 months

[1] In the first question, n = 193, and in the second question, n = 77. The second question was asked only of CFOs who say they spent the most time on other (nonfinance) roles in the past 12 months.

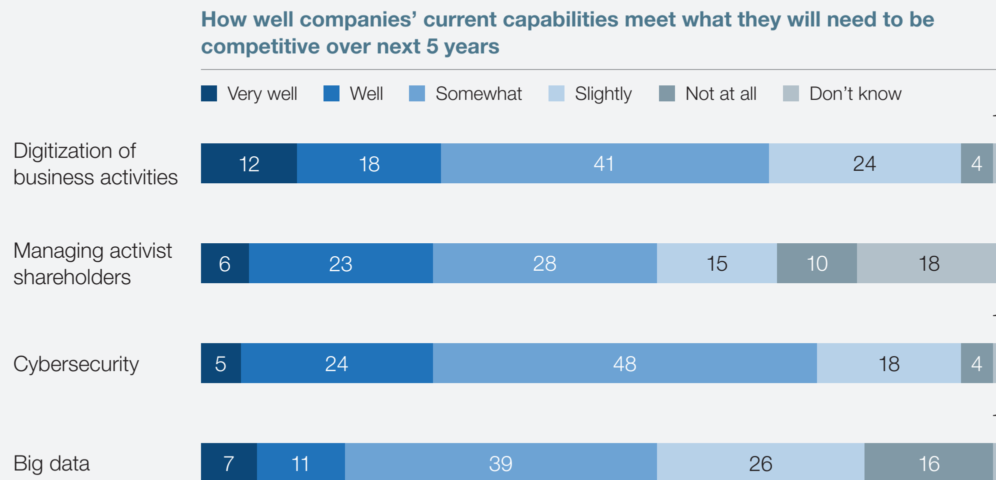
What’s more, CFOs themselves and respondents in other roles believe that CFOs can create value in several ways, and not necessarily by fulfilling traditional duties. Eighteen percent of CFOs say that, in the past year, they have created the most value for their companies through their traditional finance work. But others are most likely to cite strategic leadership (22 percent) as the area where they’ve created the most value. Looking ahead, CFOs would prefer to spend less time on traditional finance activities in the next year—and more on strategic leadership (two-thirds of all respondents say CFOs should spend more time here), organizational transformation, performance management, and big data and technology trends.

Still, the nonfinancial responsibilities—including those related to technology—are putting many CFOs on alert. Less than one in three believe their companies have the capabilities they need to be competitive in their digitization of business activities. Fewer than half feel their companies are well prepared or very well prepared to be competitive on their cybersecurity capabilities (Exhibit 3).

Exhibit 3

For newer activities and trends, such as digitization, few CFOs say their companies are prepared to be competitive.

% of CFOs, n = 193



The need for more strategic CFO leadership

Top executives acknowledge the value that finance chiefs bring to their companies, and CFOs themselves agree.[2] In matters of finance, both groups largely agree that CFOs are very involved members of their teams. They also agree that CFOs should spend more time as strategic leaders in the years ahead.

But as the CFO's role evolves, so are the expectations that other company leaders have for them. Not surprisingly, then, the data show that CFOs perceive some of their contributions differently than do others in the C-suite. Majorities of CFOs and other C-suite executives agree that their CFOs are significantly or the most involved in bringing deep financial expertise to discussions, focusing group discussions on the creation of financial value, and serving as the executive team's public face to financial stakeholders. But for activities beyond finance, the results suggest there's a gap between the leadership that CFOs currently demonstrate and what other business leaders expect of them. For instance, 72 percent of CFOs say they are significantly involved or the most involved executives in allocating employees and financial resources. Yet only 29 percent of other C-level executives say the same about their CFO peers.

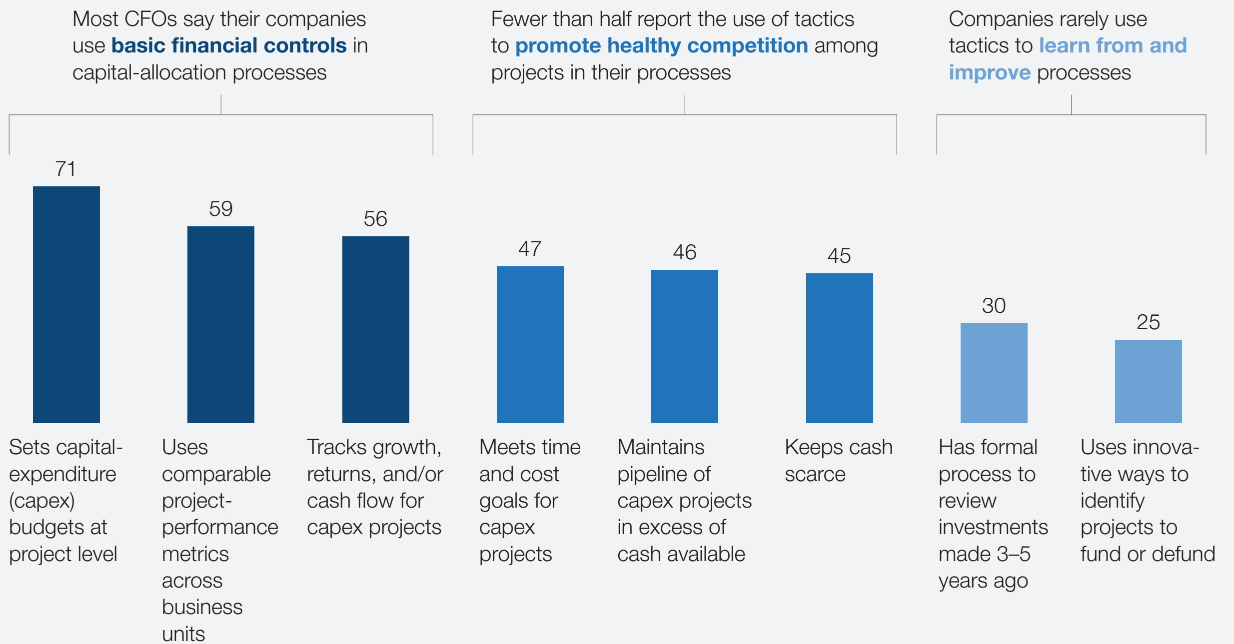
CFOs also rate the performance of their finance functions differently than their fellow executives. While 87 percent of CFOs rate their finance functions as effective, only 56 percent of other C-level executives say the same. These groups also report differing views on the challenges that finance functions face. Whereas CFOs are likelier than their peers to cite a lack of resources and skills as barriers to effective finance-function performance, others in the C-suite most often identify a lack of innovation mind-sets.

CFOs and their C-level peers agree that finance leaders should spend more time leading. But the results suggest a gap between finance chiefs' current leadership on the executive team and what others expect.

Exhibit 4

Companies tend to use basic financial controls to allocate resources—but few foster competition for cash or improve their allocation processes.

% of CFOs who agree with each statement about their companies' capital-allocation practices (outside of M&A)[1]



[1] The other answer choices were "neutral," "somewhat disagree," "strongly disagree," and "don't know."

In finance processes, there's room for CFOs to innovate

On the whole, CFOs recognize the need to move beyond traditional or textbook practices. But few say their companies use innovative methods to make decisions. Roughly two in three CFOs say their companies do not yet have the capabilities for agile decision making, scenario planning, and decentralized decision making they'll need to be competitive in the coming years.

Likewise, many say their companies use basic financial controls in their decision making—but few report the use of more advanced practices. When asked about their capital-allocation processes, most CFOs agree that their companies set capital-expenditure budgets at the project level, use comparable metrics across business units, and track the results of specific projects (Exhibit 4). These practices support the foundation of a strong capital-allocation process. Fewer CFOs, though, report using tactics that would foster further learning or innovation. Just 30 percent of CFOs say their companies formally review investments made three to five years ago, and one-quarter say they're using new methods to identify funding opportunities.

Looking ahead

In response to some of the challenges that the survey results revealed, here are a few steps that we believe CFOs and their companies can take.

- *Assert proactive and strategic leadership.* According to the survey, CFOs perceive some of their contributions to the C-suite differently than other leaders do. One such divergence is the CFO's involvement in strategic decisions, suggesting that finance leaders have more room than they may think to leverage their expertise and influence—especially since many other C-level executives believe CFOs should spend more time on strategic leadership in coming years. Finance leaders could start by more explicitly articulating the scope of their role, which may help finance leaders increase the engagement and effectiveness of the executive team.

- *Adopt an investor's mind-set—and more innovative practices.* Many CFOs are aware of their financial stakeholders' interests, but less than half agree that their companies keep cash scarce—which investors often see as an indication that a company will be disciplined in its investments. The finding highlights the importance of demonstrating capital discipline by translating an investor mind-set into a day-to-day management style. That could also mean adopting innovative finance processes: for example, moving away from a typical, annual capital-budgeting process toward a more agile one, with flexible budgets, quick decision making, and a performance-management system to match. Maintaining a more investor-based mind-set could also help preclude the kinds of misunderstandings that draw the attention of activist investors, which less than one-third of CFOs say their companies are well prepared to manage.

- *Embrace technological advances.* If new technologies and trends are adding to the evolution of the CFO's role, they also have the potential to make it easier for finance leaders to understand current business complexities. There is a wide range of tools that can help CFOs benefit from big data and the digitization of finance processes; for example, software that automatically completes repeatable, standardized, or logical tasks, such as processing transactions or integrating data to derive business insights. CFOs should increasingly use such tools to lead complex enterprise-resource planning efforts, among other challenges that they are being tasked with managing. ■

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[1] The online survey was in the field from January 19 to January 29, 2016, and garnered responses from 545 respondents representing the full range of regions, industries, and company sizes. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[2] To account for demographic differences between company-level CFOs (who tend to work for private, smaller companies) and all other C-level respondents (who tend to work for public, larger companies), we compared the responses to these questions from CFOs and other C-levels at only public companies and at only companies with larger revenues. As we saw between all company-level CFOs and all other C-levels, the results indicate similar and statistically significant differences (at a 95 percent confidence interval) between public-company CFOs and other C-levels, and large-company CFOs and other C-levels, for the questions on CFO value, CFO leadership, and the finance function.

The contributors to the development and analysis of this survey include **Ankur Agrawal,** a partner in McKinsey's New York office; **Brian Dinneen,** a consultant in the Boston office; and **Ishaan Seth,** a senior partner in the New York office.

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OCTOBER 2015

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Corporate Finance Practice

Profiling the modern CFO: A panel discussion

Seasoned finance chiefs explore revamping business models and coping with new competitors, currency risks, and changing capital structures.

At McKinsey's annual Chief Financial Officer Forum, in London this June, CFO and chief operating officer Samih Elhage of Nokia Networks, Manik ("Nik") Jhangiani of Coca-Cola Enterprises, and former Alstom CFO Nicolas Tissot took up some of the challenges facing today's finance chiefs. Over the course of an hour, the panelists explored the pricing threat posed by a new breed of low-cost competitors now rising in emerging markets, the risks from the resurgent volatility of currency markets, and the brave new world of cheap debt financing and its implications for capital structures.

The discussion, moderated by *Financial Times* Lex column editor Robert Armstrong, shapes a profile of the skills and tactics that define the modern CFO. The edited highlights below begin with the question of whether CFOs should make challenging the existing business model part of their role.

Nik Jhangiani: A business never gets to the point where it has the ideal model. The world is changing so fast around us. Even in a business that you think is stable and predictable, the operating model needs to continue to evolve, just given what technology is doing. At Coca-Cola Enterprises, we don't conclude, at a single point in time, that the business model needs to change—that's something we challenge ourselves on through our long-range-planning process every year.

For example, we have probably the largest sales force in Europe of any packaged-goods company, and I almost *have* to challenge that. Is it

really bringing us the value today that it did five years ago? How many people want a salesperson calling on their stores or outlets helping them to place an order and to merchandise when so much more can happen through call centers and technology? You definitely don't want to lose the human touch and the relationships, but you do want to allow your sales force to be more efficient, effective, and focused on what the customers view as an added value.

This is something you, as CFO, need to challenge almost every day—to ask if your company's business model is fit for purpose today and, more important, if it is fit for purpose for the future. What do we need to change, without suddenly having to make a wholesale change tomorrow? It needs to be constantly adapted.

Robert Armstrong: *When you realize that a major change has to be made, how do you deal with your executive board?*

Nicolas Tissot: Among the members of executive committees, CFOs are probably best positioned to challenge the businesses. They are independent from operations. And they are the only ones, apart from the CEO, who have a comprehensive vision of the company. The role of a CFO who goes beyond being a bean counter is clearly not only to be a business partner but also to be a business challenger. This is not the easiest part of the job, but it is definitely a part of the modern CFO role.

Samih Elhage: In a fast-moving industry like Nokia's, technology life cycles are becoming very much shorter. In our case, the transformational aspect of the business is becoming a way of life. We can't say, definitively, that this is really my process; this is my business; this is how I sell; this is how I buy. We *can* say that we're in a continuous-improvement process—and the process itself has to evolve.

This isn't about squeezing the budget to reduce costs. It's about significantly changing the company's processes and mode of operation. In many cases, you have to change the way you sell certain products and the way you charge particular customers. And, in some cases, you have to exit specific areas of the business. When I first came to Nokia, we were operating in ten different segments. Since then, we've made

Manik ("Nik") Jhangiani

Education

Holds a bachelor's degree in accounting and economics from Rutgers University

Career highlights

Coca-Cola Enterprises

(2013–present)
Senior vice president and CFO

(2012–13)
CFO, Europe

Bharti Enterprises

(2009–12)
Group CFO

Coca-Cola HBC

(2000–09)
Group CFO

Fast facts

Married, with 2 children

Lives in Central London

incisive and, I think, courageous changes, divesting eight of these businesses to focus intensely on the two that would give us the operating performance we were looking for.

Competitive dynamics and pricing

Robert Armstrong: *Let's talk a little about competitive dynamics. Samih, you are in a unique position there. How do you manage the company when you are constantly under pressure from large, low-cost emerging-market competitors?*

Samih Elhage: Well, competition is undeniably an important element in our day-to-day operations, because of its implications for our cost structure and for pricing. But we resist being driven reactively by the actions of competitors. We have a strong pricing strategy and controls to ensure that prices are being set at the right level—one that ensures our customers are getting value for money and that we are able to fund investment in R&D and healthy performance for our stakeholders. And, in a competitive environment, our cost structure, which is extremely lean, gives us the means to fight when fighting is what's required.

Robert Armstrong: *Let's explore that pricing theme a bit. Nik, how does pricing feed into the finances of Coca-Cola Enterprises?*

Nik Jhangiani: It is a huge element. Fortunately, in the last couple of years we've benefited from

Nicolas Tissot

Education

Holds an MBA from École des hautes études commerciales (HEC) and graduated from École nationale d'administration

Career highlights

Alstom

(2015)
Adviser to the group chairman and CEO

(2010–14)
CFO and executive-committee member

Suez/GDF Suez/ENGIE

(2008–10)
Deputy CEO, global gas and liquefied natural gas

(2005–08)
CFO and executive-committee member, Electrabel

(2003–05)
CFO and executive vice president, Energy International

(1999–2003)
Head of group financial planning and control

French Ministry of Economy, Finance, and Industry

(1995–99)
Inspecteur des Finances, the senior audit and consulting body of the ministry

Fast facts

Married, with 4 children

Member of the French-American Foundation (and former FAF Young Leader) and the Société d'Economie Politique

Independent director at Euroclear Settlement of Euronext-zone Securities

the more benign commodities environment. As recently as four or five years ago, inflation was high, and we had to find a way to pass that on to our customers and our consumers. Today, some markets in Europe are actually facing deflation, and your customers and consumers are looking at that, too. What we're not able to achieve through pricing, we have to do by reducing costs—finding better ways to be efficient at what we do.

The answer isn't always about the absolute price the market will bear. Sometimes, it's much more about what you can do from an overall revenue-growth perspective. In addition to cutting costs and increasing prices, how do you get the right mix of products to generate more transactions? How might you change your packaging strategy to increase revenue growth? For example, would consumers want—and pay a slight premium for—a smaller or differentiated or more premium package?

Nicolas Tissot: In heavy industries, the pricing environment is always driven by the business cycle. For several years, we've been in a crisis that also has some structural components. So we've had to adapt structurally to the emergence of new competitors from places with a lower cost base. We also need to adjust to the interest of our clients in our services, as well as our technology. The CFO is instrumental, for example, in launching performance and restructuring plans, setting up partnerships, allocating R&D money, and reorienting manufacturing investment.

On pricing, we need to adapt rapidly or we'll lose every sale. At one time, deals targeted a level of profitability that fully rewarded our investments. But when there is overcapacity in the market and when—to break even—competitors fight to keep factories running, sometimes you end up settling for the second-best price. At Alstom, the CFO, who personally approves every

Samih Elhage

Education

Holds a bachelor's degree in electrical engineering and in economics from the University of Ottawa, as well as a master's degree in electrical engineering from École Polytechnique de Montréal

Career highlights

Nokia Networks

(2013–present)
Executive vice president and CFO

(2013–present)
Chief operating officer, Nokia Solutions and Networks

Nortel

(2009–10)
President, carrier voice over Internet Protocol (VoIP) and applications solutions

(2008)
Vice president and general manager, carrier VoIP and applications solutions

(2007–08)
Vice president, corporate business operations

Fast facts

Married, with 2 children

Pastimes include world music, traveling, walking, and golf

bid above €50 million, has to take into account those specific periods and relax the margin targets appropriately.

Foreign-currency risk

Robert Armstrong: *Currency risk has returned to the corporate world's attention over the past year, with the strong dollar and the fluctuations of other currencies. How do you manage the risks?*

Samih Elhage: I start with how we should achieve our performance goals and then ask how we cope with the challenges of all external aspects, including currency fluctuations. In our business, we depend mainly on four currencies—the euro, the US dollar, the Japanese yen, and the Chinese yuan. We usually get our performance plan approved by the board in Q4 and make any changes at the beginning of the year. From there, I ask teams to develop their performance plans reflecting the impact of currencies. Their underlying business objectives have to be achieved from an operating-profit perspective, and that comes down to cash.

If the effect of currency shifts help the top line, that's assumed to be in addition to the team's performance goals. If currency shifts affect costs negatively, the team has to find some way of compensating for that.

Is that challenging? Absolutely. It adds to the pressure on teams to meet their goals. Are we making progress? Yes, we are. But costs associated with hedging have to be included in the accounting statements, and they have cash implications. Our teams know that they just have to make the numbers add up.

Nik Jhangiani: The countries in which Coca-Cola Enterprises operates give us a fairly natural hedge—because our revenues and a great deal of our cost base are local. In fact, we produce 90-plus percent of our products within a given market. It's difficult and expensive to transport water. Producing locally gives us another natural hedge.

The issue is more with our commodity exposures, which could be in different currencies. That's where we make sure that we're covering risk through transactional exposures, for which we hold teams accountable—having hedging policies in place and ensuring that all our transaction exposures are covered, at least on a rolling 12-month basis (with lower levels of coverage going out 36 months). Teams are responsible for making sure that currency risks are covered through pricing and cost structures and so on.

Our hedging strategy is very clear. We're not looking to beat the market. We are just trying to increase certainty around our cost structure. We do not hedge for translational currency conversion or exposure. When we communicate with the market, we actually give guidance and provide our performance data both on a currency-neutral basis and then with the impact of currencies. The transaction part is built into the information we provide.

You can't keep changing what you do in volatile times, as that volatility will always be out there. At times, translation or currency conversion works and has some benefits, and at times it doesn't. You have to try to ride through that cycle without being reactive and changing things, unless you see something that isn't working over the long term.

Nicolas Tissot: We see our business as being a supplier of industrial equipment and associated services, not playing games with the fluctuations of currencies. As soon as an order is firmed up, we have a full analysis of the currency flows. Then that exposure is systematically hedged over the horizon available in the market, with a rolling forex strategy. We have pretty significant activity in that

respect. To avoid paying too much in fees to the banks, we use an electronic platform. The banks own the platform and it is competitive for any forex trade that we handle to hedge our exposure.

Capital structure

Robert Armstrong: *One of the ironic consequences of the financial crisis is that debt financing is cheap and easy to get unless you're a bank. It's so cheap, why have any equity at all? How do you make capital-structure decisions in this context?*

Nicolas Tissot: Regarding debt financing, over the past few years there have been times when we've needed to think fast, act fast, and be opportunistic. There are imperfections in the market, and many of us have seized the opportunities they create. But at the same time, you always have to keep the long-term view in mind.

Alstom is in a very cyclical industry, and sometimes you can lose sight of your position in the cycle. When things are good, there's a risk of leveraging too much; when the hard times come back, you burn a lot of cash and quickly deteriorate your financial structure and therefore your rating, which leaves you little if no access to debt markets. We manage our financial structure—the structure of the balance sheet—with that in mind. At the peak of the cycle, we want to have almost no leverage, while at the trough we accept more.

Samih Elhage: At Nokia, our capital-structure decisions are guided by the principle that we should always do our best to give back to shareholders. In the past two years, as we purchased Siemens's share of Nokia Siemens Networks and sold the device business to Microsoft, we put in place a program to improve our capital structure and to return €5 billion to shareholders over three years.

Why have equity at all? Our philosophy is that there should be a balance. You should go to the market when you must, but you also need a very strong capital structure to defend the business and to drive the right investment at the right time.

Nik Jhangiani: We sold the US business back to the Coca-Cola Company in 2010 and formed the new Coca-Cola Enterprises. That included much of the debt we had, as well. We continue to generate a great deal of free cash flow, but at the same time we also realized that we were very underleveraged and didn't have the most efficient balance sheet. So we set a leverage target of two and a half to three times net debt to EBITDA, compared with where we were before the sale, which was closer to one to one and a half times net debt to EBITDA. It could have been lower, but we picked a level that we saw as the right starting point for the journey we wanted to make. We would slowly lever up toward that level, so this wasn't a big one-shot bang, and we wanted to make sure we had enough dry powder for potential activities.

The leveraging up, along with the free cash flow that we continue to generate, and a strong focus on that cash-conversion rate gives us a solid pool of free cash flow. In the absence of M&A, the best way to use it was to return it to shareholders. Over the last four years, from the formation of the new Coca-Cola Enterprises through the end of 2014, we have returned approximately $8 billion to shareholders. ■

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Corporate Finance Practice

Building a better partnership between finance and strategy

The growing strategic role of CFOs may create tension with top strategists. That's a missed opportunity for teaming up to improve company performance.

Ankur Agrawal, Emma Gibbs, and Jean-Hugues Monier

Two-thirds of all executives agree that the best way for CFOs to ensure their company's success would be to spend more time on strategy.[1] Indeed, it is increasingly common for CFOs to be taking on more strategic decision making. Companies value the hard data and empirical mind-set that a finance chief can lend to strategic planning, especially around forecasting trends, building strategic capabilities, or managing government and regulatory relationships.[2]

Yet as CFOs map out what can be a wide range of strategic responsibilities, they may encounter challenges and even turf wars from some traditional strategy leaders, such as chief strategy officers (CSOs) and business-unit heads. These seldom boil over into public view, but we often see signs of tension where the two roles increasingly overlap.

Such friction is destructive—and a missed opportunity. Working together, CFOs and CSOs have the stature to challenge biases and influence how the top team makes decisions to improve a company's performance. In many cases, a CSO may be better placed to take on certain roles typically managed by the CFO, such as owning the resource-allocation map or the M&A process. Many CFOs are the first among equals on a company's board of directors and can assist CSOs at improving board productivity on strategy. Having explicit conversations about expectations and the division of such roles will improve the dynamics of strategic

decision making—by ensuring a better link between a company's capital allocation and its strategic priorities, by better informing a search for growth, and by better balancing a company's strategy for long-term growth with its short-term strategy for earnings and investors.

Better linking capital allocation to strategic priorities

Research by our colleagues finds that, on average, companies allocate 90 percent or more of their resources to the same projects and activities year after year, regardless of changes in the environment or their strategies.[3] Dynamic companies that reallocate resources more actively deliver better, less volatile annual returns to shareholders, on average, than their more dormant counterparts[4]—particularly during economic downturns.[5]

CSOs and CFOs each bring insights to create a better link between resource allocation and strategy in the corporate-strategy-development process. This means, among other things, creating a distinct corporate- or portfolio-strategy process (rather than just aggregating business-unit plans); encouraging more frequent conversations among small groups of senior leaders on an ongoing basis, rather than annually or every three to five years; and ensuring that the corporate-strategy and budgeting processes are fully integrated with capital-allocation processes (including M&A and divestment). This integrated view of strategic direction and resulting allocation of corporate resources demands close collaboration between finance and strategy.

In the case of one North American healthcare company, the CSO set up a planning council that included the CFO to discuss strategic issues, growth opportunities, and funding needs. For each of the promising opportunities—which carried the imprimatur of both the CFO and the CSO—the council appointed a strategic leader. Each leader was tasked with creating a deliberate dialogue with existing business leaders and cultivating their support for more than a dozen related initiatives well in advance of the annual allocation process. As a result, the council was able to aggressively challenge the expenses attributed to running the business and set aside a defined amount for growing the business instead. This result clearly was achieved due to the foresight and trusted collaboration of the CFO, the CSO, and their teams.

CSOs can also track how critical resources such as growth investments and talented R&D teams are used. This allows managers to assess whether resources are allocated to support strategy—or whether each year's capital allocations unduly influence the next.

Finally, CSOs can pay close attention to the way strategic decisions are made, for example, by managing the executive team's strategic agenda and prompting debate on competing options and scenarios to account for inherent sources of bias. Often this means bringing external data into the room to help reanchor discussions away from assumptions based on prior decisions. The CSO at a consumer-products company, for example,

Working together, CFOs and CSOs have the stature to challenge biases and influence how the top team makes decisions to improve a company's performance.

used this approach to good effect when managers found themselves facing a major disruption in a core market. The CSO shepherded the executive team through a series of strategic decisions that allocated resources away from traditional cash cows. Instead, she shifted attention and resources into a disruptive technology identified by the company's widely accepted strategy review as the future of the business. To guide the discussion, she clearly laid out the level of resources needed to fund the agreed-upon strategy, reminded the executive team of the rationale for the change of direction, and carefully positioned each decision to reduce the likelihood of bias.

Looking outside the company for insights into growth

CFOs agree that companies need to step up their game in a wide range of growth-related activities, particularly driving organic growth, expanding into new markets, and pursuing M&A. Recent McKinsey research shows that more than 60 percent of growth comes from riding on favorable tailwinds—that is, doing business in markets that are growing well and where com-panies enjoy a competitive advantage.[6] However, a 2010 survey found that less than 15 percent of executives consider such macroeconomic trends when they develop strategy, and only 5 percent take their competitors' strategies into account.[7] Moreover, less than a quarter even look at their own internal financial projections and portfolio performance. Little wonder that companies and their CFOs struggle to find growth; they're looking at a mirror and not a window.

CSOs are well placed to help correct this. Many CSOs own the organization's trend-forecasting and competitor-analysis function. Good trend forecasting involves creating proprietary insight into trends, discontinuities, and potential shocks to find growth opportunities and manage business risk. Similarly, good competitor analysis involves gathering competitive intelligence, closely tracking the behavior of competitors, monitoring their potential responses to a company's strategic moves, and evaluating their sources of competitive advantage. All are necessary to understand how a company creates value—the foundation of the strategic decisions that best balance a corporate portfolio for risk and return. Armed with such insights, CFOs and CSOs together are better placed to go beyond a CFO's traditional strengths in managing the portfolio, navigating it toward growth opportunities, setting objectives for organic growth, and planning a strategy for M&A.

The experience of a CFO and CSO at one industrial conglomerate is illustrative. The newly appointed CSO developed a proprietary view of what contributed to each business's growth and injected that insight into corporate-strategy discussions. Underlying factors included, for example, projections down to the level of how much new commercial floor space would be built in Latin American cities—a central variable in forecasting demand for the company's most advantaged products, such as electrical wiring. The CFO, in turn, provided data and analytical rigor in assessing the business case for each product. In particular, the CFO created a database that empirically evaluated pricing relative to demand and the number of competitors in each submarket. With information at this level of detail, the executive team could see which businesses in the company's portfolio were the best positioned to capture pockets of growth. Not only were they better able to set targets for organic growth, which the CFO now uses to manage performance, but they also used the information to develop a clear acquisition and divestment strategy.

Taking a long-term strategic view to offset short-termism

A key challenge at any company is balancing the long-term growth strategy against the demands of

increasingly vocal short-term investors. Working together, a strategist's deep understanding of regulation, innovation, and microeconomic industry trends complements a CFO's understanding of cost and revenue, capital allocation, and stakeholder issues. Together, they can put forth options that improve both a company's short-term earnings and its longer-term growth in a way that is compelling to management, boards, and investors.

To facilitate collaboration, one company explicitly rotates strategy and finance professionals between the two teams. Formal structures, such as the strategic-planning team, include people from both—strategic planning has two from each—so that they start the budgeting process hand in hand. That enables both sides to see how resources align with the long- and short-term strategies as they make long-term resource allocations, evaluate make-or-buy decisions, and challenge the business case.

Working together, finance chiefs and strategy leaders can complement each other, helping the CEO, the board, and the rest of the executive team face the challenges of creating growth over the long term in the face of so many short-term challenges. ■

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