Changing Role of CFOs

by *Sundar Sankaran*[*]

Changes in the business environment during the last few years ushered in a transformation in the role of the Chief Financial Officer (CFO). Enron, Global Crossing, Tyco, WorldCom and other corporate scandals in the United States will catalyze this transformation.

The Unbelievable Past

Until a few years ago, the role of the CFO was limited to –

A. **Accounting and the related statutory audit** Many organizations would complete the audit around the statutory deadline, to keep the window for dressing up the accounts open.

B. **Resource mobilization** In India, this generally meant going to an all-India or state level financial institution. The CFO had annual interactions with a consortium of bankers for working capital financing (cashcredit facilities). A merchant banker would be appointed for public issues. These entailed conferences all across the country (and abroad). The CFO and his trusted lieutenants viewed these conferences as paid holidays.

C. **Investment** If the company was cash rich, then the CFO had to manage investments. The moneys would typically be placed in inter-corporate deposits or "ready forward" deals in government bonds or units of Unit Scheme 1964 or equity. If the surplus was significant enough, investments would be routed through an investment subsidiary. Investors appreciated *'management topping up earnings through prudent management of surpluses.'*

D. **Budgets and Long Term Plans** These were an annual "ritual" for many Indian companies. It entailed plugging more recent numbers in the previous year's spreadsheet. Actual results would occasionally be compared with projections, to know the *extent of the gap*, rather than the *reasons for the gap*.

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The Unstable Present

A survey by CFO Research Services (a unit of CFO Publishing Corp.) and Cap Gemini Ernst & Young[1] provides interesting insights about the United States –

- Only 25% say the rest of the organization views finance as a value-added function to be consulted on all important decisions.
- Only 39% are very satisfied that finance consistently influences the decisions that drive shareholder value.
- 63% are saddled with inadequate, non- or partially-integrated budgeting, forecasting, and decision support systems. When asked what obstacles are holding back transformation, 56% cited technology and 59% identified lack of senior management support—a signal that many companies have yet to connect IT capabilities with finance production.

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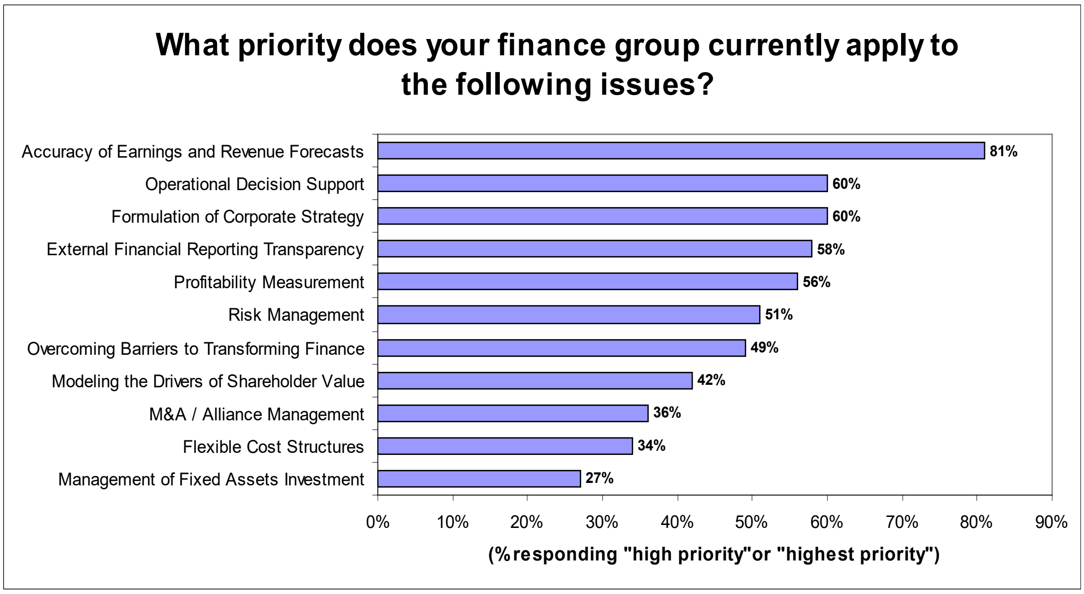
According to the same survey, 81 per cent of the respondents viewed accuracy of earnings and revenue forecasts as ‘highest priority’ or ‘high priority’. [This number may go up with the recent Sarbanes–Oxley Act, 2002 which has increased the responsibility of companies’ management (CEO, CFO) for the accounts presented]



A few highlights of the current scenario in India are -

A. **Accounting – enhanced role** Quarterly reporting has ensured that the CFO’s accounting role is no longer an end-of-year routine. Early completion of audit and reporting of annual results (preferably within 2-3 weeks of the end of the financial year) has become a test of effectiveness of the finance department and transparency of the company. Many companies even re-state the financials based on US Generally Accepted Accounting Principles (GAAP).

B. **Multiple funding options** *Financial institutions have become the safety net, rather than preferred source.* Quality borrowers prefer the benefits of direct access to financiers, local and international. There are fewer concerns about placing large blocks of equity with outside investors, who can even seek a seat in the Board. Financial products like securitisation have emerged. Innovative financial instruments are increasing the level of sophistication, risk perspective and financial market feel expected of CFOs.

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C. **Problems of surplus** Investment income in a non-investment company’s financial statements is no longer an unqualified positive. It is often viewed as *‘management digressing from its business and increasing the risk profile’.* Investment in treasury bills is seen as a sense of maturity, not lost opportunity. ‘Ready forwards’ have become ‘repos’. And significant holding of units of Unit Scheme 1964 does not necessarily imply a sound balance sheet.

   Consequently, surplus cash has become a source of concern, rather than comfort, for CFOs. Will the cash invested in low yielding treasury bills, pull down return on equity? Will it lead to a hostile bid by an acquirer? Should surplus funds be given back to shareholders through dividends or buy-back? What if the funds are required later? CFOs spend sleepless nights grappling with these issues.

D. **Budgets and business plans are serious business** The planning horizon (in terms of number of years) has come down. But business plan, and soundness of the underlying business model, have gained in importance. Budget is not just a document, but a process to delegate responsibility and manage performance. It is getting more closely integrated with the operations of the company.

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E. **Critical role in strategy** This covers both inorganic and organic growth.

   Inorganic Growth **-** Declining product life cycles and criticality of time to market, have made mergers, acquisitions and alliances the order of the day. CFOs need to proactively review the options. The CFO of a pharmaceutical company I knew, carried a list in his pocket. It not only mentioned the companies that interested him, but also the order in which he proposed to take them over!

   Organic Growth - The CFO has to put in place systems that can quickly generate numbers to evaluate strategic options. What, for instance, are the consequences of increasing the product variations and reducing the batch size? Or, what are the economic benefits of a decision to outsource? Or, what is the profitability of a channel or a customer? These apart, support in investment analysis, performance management, pricing etc. continue, but with a greater emphasis on creating the future than recording the past.

F. **Intangible assets are invaluable** The complexion of balance sheet of companies too is changing. Intangible assets are gaining importance. Valuation of intellectual property has therefore become critical. What is the value of your company's brands? What is the value of your company's human resources? *CFOs who do not have the answers will soon become UFOs (unidentified flying objects)!*

G. **Internet raises new issues** The internet has thrown up an entirely new set of challenges. How should the company transact business over the net? Should the company procure or supply based on internet orders? When does the title to the goods pass? What would be the jurisdiction for determining taxes and duties payable? Which payment gateways would be preferable?

   With so much information hosted in servers that are connected to the world wide web, how should information risk be managed? How to prevent hacking? How to maintain confidentiality of sensitive information? These are some of the newer concerns for the CFO.

H. **Investor relations influences valuation** Throughout the year, the CFO has to maintain two-way communication with investors, analysts etc. The openness of such communications, and proactive disclosure of unusual events and trends have become hallmarks of transparency that determine how the stock market values public companies' equity. *A marketing orientation is required for the CFO to maintain cordial relations with these investors.*

I. **Conferences are for business** 'Merchant Bankers' have become 'investment bankers'. 'Conferences' have given way to 'road-shows' and 'one-on-one' meetings, that are anything but paid holidays. These call for tough preparations by the CFO and other members of the team.

J. **Corporate governance finally appreciated** Board meetings are no longer held over the dinner table! Corporate governance measures have ensured outside participation in board meetings, which are held with adequate notice and a specific agenda. Sub-committees of the board get to a level of detail that was traditionally considered out of bounds.

K. **Insider trading can be dangerous** Promoters and senior executives are required to be more careful at the dinner table, or any table for that matter. A casual comment could lead to serious implications related to insider trading.

More Turbulence in Future?

"Creating an effective office of the CFO is not simply about cash and dollar precision any more. It is about making business judgments based on reasonable accuracy and relevance. It is about giving up control of data in exchange for having more authority over information that the executive management team uses to make the most fundamental business decisions."[2] I expect four major changes -

A. **Enhanced role of CFO in strategy formulation** The CFO will become an important partner of the CEO to *balance the risk and return dynamics of the company's business strategy*. This will create a need to understand deeply the company's manufacturing and business operations and its interactions with the environment.

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From an organization structure point of view, it may be worthwhile to position finance professionals in the various divisions. This could create matrix-like structures where some members of the CFO's team would work administratively in the various divisions, but have a functional association with the Office of the CFO. A finance *Community of Practice* within the organization could emerge as a knowledge management tool for the finance professionals.

The CFO may have to aggressively push for integration of various databases within the company, so as to have the requisite financial and non-financial measures to provide information support to line managers, peers and the CEO. Innovative data-mining would help the CFO play a value-added role in the organization.

Strategy formulation exercises would be backed by application of *game theories* and *probability driven expected values*. *Knowledge of accounting standards and financial markets will be necessary, but not sufficient conditions, for a good CFO.*

The information requirements for the strategy formulation role are partly internal, and partly external. *Given the nature of internal information required, activity based costing may gain in acceptance*. C*hanging business models may also give a thrust to life-cycle costing and target costing.*

In organizations that neither have an 'Office of CEO' (a team of professionals assisting the CEO on all strategic issues) nor a dedicated strategy / corporate planning department, the role of collecting external information too could fall on the CFO. In such situations, the CFO could have a core strategy group that would assist him in all aspects of strategy.

B. **Enhanced role of CFO in strategy implementation** As partner of the CEO (and the rest of the organization), the CFO has an important role in implementation of strategy. Given their background and training, CFOs are generally more comfortable with structured formats.

The balanced scorecard, which introduces some structure to the amorphous strategy process, could emerge as a leading tool for the CFO to support strategy implementation. This could also be the basis for CFOs to objectively appraise increasingly skeptical market analysts, about the performance of the company.

Here are four principles that CFOs can rely on to keep themselves — and their companies — on track: (1) Understand how your company creates value (2) Integrate financial and operational measures (3) Keep the measurement system transparent and uniform (4) Focus on the dialoque.[3]

C. **Elimination of inherent conflicts of interest** Segregation of front-office and back-office becomes an internal check in asset-based finance businesses. Thus, the fund manager is clearly different from the accountant. Why should it be any different in other businesses? Why, for instance, should the treasury person also account the transaction – and settle the trade in the market. Similarly, isn't there a danger in using market valuation as one of the parameters to judge CFO's performance, and simultaneously giving him a role where he can window-dress the earnings?

Transfer of accounting and audit responsibility to an independent "Compliances & Accounting" department, that would report to the Audit committee of the Board (or an identified director with a finance and accounts orientation, other than the CFO), would ensure a strong internal check. This would also strengthen the independence of the external auditor, who would be outside the influence of the CFO or CEO.

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CFOs should be happy with this development. "A major study Coopers & Lybrand conducted in 1989 showed that most CFOs were still spending 75 to 80 per cent of their time on fiduciary issues, essentially outside reporting. Leading-edge CFOs were only spending about 25 to 30 per cent of their time on fiduciary issues. But we believe the vision for the office of the CFO in the twenty-first century ought to be an office that spends only between 10 to 20 per cent of its time on fiduciary issues. The rest of its time should be spent partnering with business operations executives in value–adding decision making for the business."[4]

D. **Role in Outsourcing** With a broad change in business model towards greater outsourcing, organizations are likely to have vendors for a greater number of specialized activities. These would span information technology, to human resources to marketing and other functions. Within the finance function, payroll processing, employee benefits management, management of accounts receivable / payable, investment back office etc. could be outsourced.

Maintaining relationships with these vendors would become a critical factor driving business success. This relationship role would typically be played by a Chief Resources Officer (CRO).

The CFO would provide the information support for the outsourcing decision. Further, where cost considerations are the key driver of outsourcing (for instance, in traditional industries with fewer non-cost challenges), the CRO may well report to the CFO. However, in dynamic and newer sectors, where outsourcing will be driven by strategic considerations, the CRO would report to the CEO and be a key member of the strategy team[5].

Conclusion

"But at the end of the day, there's no one-size-fits-all template for today's CFO. A lot depends on the nature of the company's business, as well as its size. Smaller companies, for example, don't have the complicated financing schemes or vast array of product and service lines that require the same level of accounting virtuosity and strategy prowess. And CFOs at Fortune 500 companies don't have the same constant pressure to raise capital because they've already got plenty."[6]

With such responsibilities and demands, is it any wonder that good CFOs are at a premium in the market?

No organization can wish away the enhanced role of the CFO. With such responsibilities and demands, *is it any wonder that good CFOs are at a premium in the market?* Even setting up an effective office of the CFO is a challenge. We at Advantage-India help companies meet this challenge.

Smaller companies that cannot afford such CFOs need not despair. They can outsource the CFO's role. *If you cannot own them (to be politically correct, let us say 'recruit them'), you will need to hire (to use the latest buzzword 'outsource') the role.*

And all you CFOs and budding CFOs – the enhanced role will come with enhanced compensation. But bear in mind the greater personal risk. The Sarbanes-Oxley Act is only a beginning – you can expect more regulation-driven responsibilities – and more professional indemnity policies from insurance companies!

Footnotes

[1] CFO Research Services and Cap Gemini Ernst & Young, "*CFOs: Driving Finance Transformation for the 21st Century*", May 2002 (mail survey of 265 senior finance executives and interviews conducted with 12 more working at companies with annual revenue in excess of US$500mn)

[2] Thomas Walther, Henry Hohansson, John Dunleavy & Elizabeth Hjelm (Coopers & Lybrand), "*Re-inventing the CFO: Moving from Financial Management to Strategic Management*", pp 76-77, 1996, McGraw-Hill

[3] Timothy Koller & Jonathan Peacock, *"Time for CFOs to step up",* The McKinsey Quarterly, 2002 Number 2 Risk and resilience

[4] Thomas Walther, Henry Hohansson, John Dunleavy & Elizabeth Hjelm (Coopers & Lybrand), "*Re-inventing the CFO: Moving from Financial Management to Strategic Management*", pp 5, 1996, McGraw-Hill

[5] Jain Balwant & Sundar Sankaran, "*Value Creation in IT Outsourcing*", 2002, www.newsNmuse.info

[6] "*The Changing Role of the CFO",* http://knowledge.wharton.upenn.edu