Super CFOs : Competencies for Success

by Sundar Sankaran[1]

Much has been written about the traditional roles of CFOs viz. resource mobilization, capital structure, investments, accounting, budgeting and management control. This article goes beyond traditional roles to highlight newer challenges. It answers some questions, but leaves several unanswered. The objective is not to provide the silver bullets that will make Super CFOs, but give pointers to the direction in which the wind is blowing. Hopefully this will get finance professionals thinking about the value they bring to organizations, and potential discontinuities in the horizon. This can help them chart their own paths towards becoming Super CFOs.

The Paradigm Shift

One shift that is well chronicled is the pace of change in the environment. This has put a premium on Rapid Action Forces within companies. A blend of proactive approaches and reactive capabilities has become essential for every company.

People from Peter Drucker, the management guru to Shekhar Jichkar, the neighbourhood HR professional, claim that people are the key assets of the company. Henry Paulson would reason that customer relationships are a key strength of Goldman Sachs, the global investment bank. The head of technology at Nokia will claim to have contributed significantly to the company's future revenue streams. Are these claims justified? If yes, are such significant sources of strength – tangible or intangible - reflected in the numbers that CFOs generate and markets gyrate to? Can we confidently say that our current accounting and financing principles capture and record all the value inherent in organizations?

Maximising shareholder value' has become the *gayatri manthra* of CFOs

Most finance professionals take business decisions on the paradigm of "maximizing shareholder value". This has become the *gayatri manthra* of several generations of CFOs in India and abroad. Not surprisingly, an Ernst & Young survey in India of 92 senior financial managers revealed that shareholder value was the top CFO concern for 84 per cent of the respondents. The top 7 concerns were:

Top Seven CFO Concerns	***% of CFOs saying "most important"***
Shareholder Value	84
Business strategy planning	74
ERP integrity	64
Effective financial structure	63
Working capital management	60
Technology changes	59
Corporate Governance	58

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Leading management thinkers like Henry Mintzberg[2] are worried that a syndrome of selfishness has taken hold of our corporations and our societies, as well as our minds. They opine “shareholders have traditionally been the ‘residual claimants’ on the corporation – those who took the surpluses, namely the profits, after the other claimants have been paid off. Now the corporation is managed for those profits, no matter how much pressure that places on employees. Shareholder value thus drives a wedge between those who create the economic performance and those who harvest its benefits. It is a *wedge of disengagement*.

Another interesting thought expressed in the same article is that “shareholders have co-opted the chief executives by rewarding them disproportionately for the performance of the entire enterprise. Through options and bonuses, they have bought off the chiefs…. Underpinning all of this is a massive set of assumptions: that the chief executive is the enterprise, that he or she alone is responsible for the entire performance, and that this performance can be measured and the chief executive rewarded to do the shareholders’ bidding[3].

The roles and challenges of the CFO need to be seen in this backdrop of a paradigm shift in the *role of the corporate* and the *measures of its contribution and strength.*

USP of the CFO

What accounts for the importance of the CFO? Why do super CFOs hold center-stage in their organizations? What makes for a “super CFO”? I believe the position of CFOs in organizations hinges on three competencies –

- Understanding of how money (or value) is made (or lost) in the business
- Appreciation of the concept of risk
- Perspective on expectations of different stakeholders

Let us refer to these as the *value-chain competency*, the *risk competency* and the *stakeholder expectations competency*. It is the unique mix of these critical competencies that sets the CFO apart from other key executives, whose forte is often limited to a single facet of the business. For instance, the Chief Marketing Officer (CMO) is likely to have an excellent understanding of customers – but not of other stakeholders. The head of human resources too may deeply understand only one stakeholder viz. employees. The Chief Information Officer may be good at assessing information risk, but not financial risk, reputation risk, market risk etc.

CFOs who master these three competencies have a greater chance of stepping into their CEO's shoes

CFOs who master these three competencies have a greater chance of stepping into their CEO’s shoes when the opportunity presents itself. For others, the aspiration to occupy the corner office may remain a pipedream.

[2] Henry Mintzberg, Robert Simons and Kunal Basu, “Beyond Selfishness”, MIT Sloan Management Review, Fall 2002, pp 67 - 74

[3] ibid

The value chain competency
The production-head knows how a product is manufactured; the CMO knows how it is sold. The chain of activities starting with raw materials feeding into the business and ending with the finished goods reaching the customer, and post-servicing is often referred to as *value chain*.

There are several options for structuring the value chain. For example, should we offer the technology for exploitation by multiple manufacturers, or should we use the technology in our own products and sell directly to the consumers? Should we have own manufacturing plants, or should we outsource? Should we sell or should we lease the product to the client? CFOs, with their bird's eye view across the business are well positioned to advise on these value chain decisions.

"Casio is basically an engineering, marketing and assembly company, with very little investment in production facilities and sales channels. Its strength is flexibility. Recognising its competitors' inability to introduce new products rapidly, Casio has adopted a strategy of accelerating and shortening product life cycles.[4]

The Reliance Infotech WLL offering is an excellent case. The company appears to have rightly identified the problems faced by other telecom companies viz. declining tariffs, customer churn, high interest cost and low loyalties in the distribution chain. Through a combination of lock-in of a forward rate by subscribers, and the Dhirubhai Ambani Entrepreneurs scheme, the company has addressed these problems. Value addition through data, as distinct from voice, completes the distinctive positioning on the value chain.

> Each value chain positioning represents a 'business model'

Each value chain positioning represents a '*business model*'. Management gurus like CK Prahalad expressed the view a few years ago, that the next frontier of competition would be fought on business models. Let us delineate the roles of CEO and CFO in the context of any business model.

The evaluation of economics and risk metrics of alternative business models would clearly be the CFO's responsibility. Juxtaposing these against the company's competencies, weaknesses, market view etc. to decide on the preferred business model/s would be the CEO's call. Once the business model choice has been made, establishing financial viability, minimizing project cost, minimising running cost etc are the job of the CFO.

It would however be fatal to view the roles of the CEO and CFO in the value creation process as watertight compartments. Significant overlaps exist. The CEO seeks to leverage on the CFO's *value chain competency* for information support in strategy formulation and strategy implementation.

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[4] [4] Kenichi Ohmae, "The Mind of the Strategist", pp 117, Tata McGraw Hill (2002)

Strategy Formulation

Given the tough competitive environment, breakthrough strategic thinking is imperative at all levels and across functions. These are generally aimed at delivering the same customer value more cost effectively, or offering greater delight at the same cost.

We at Advantage-India offer a program, "Think!Strat" to encourage such thinking. But strategic thinking needs to be backed by solid information support from the CFO. It is a concern that according to a recent CFO Research Services survey[5], only 25% of the respondents feel that the rest of the organization views finance as a value added function to be consulted on important decisions. What does this imply?

- Most CFOs do not have a good handle on drivers of cost and value (which raises doubts on the *value chain competency*) and / or
- They do not have effective costing and information systems that generate the requisite information.

Some CFOs who start as accountants are often afflicted by the "*accuracy syndrome*"

Ideally, the solidity of the costing systems (like activity based costing, for instance) would be reinforced by the CFO's gut feel call on cost and value. CFOs who take themselves out of the value creation points are incapable of taking these gut feel calls. Some who start as accountants are often afflicted by the "accuracy syndrome" - wasted time and effort for an accuracy level, which is not required for the decision.

"The commander who stands atop a hill near the battleground, putting the last touches on a flawless scheme for victory while his troops are being driven from their positions, is as much of an incompetent as the officer who loses a battle through flagrant miscalculation…Fine-tuning the details when only a change in the basic course of action can ensure success makes about as much sense as rearranging the deck chairs on the Titanic.[6]

At times it makes sense to create the value within the organization (*organic growth*). There would however be occasions where it would be wiser to acquire control of value creaters who are outside the organization (*inorganic growth*). Between these two extremes, lie options like gaining access to the value drivers (*licensing*) or jointly creating the value drivers (*co-opetition*).

The CFO has a critical role in evaluating these strategic choices, and facilitating the whole strategy formulation process.

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[5] 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 in the United States.

[6] Kenichi Ohmae, "The Mind of the Strategist", pp 80-82, 111, Tata McGraw Hill (2002)

Strategy Implementation

If information support from the CFO is the bedrock on which corporate strategy is formulated, then a role in strategy implementation is a logical next step. Deal-making and valuation skills in implementing the strategic choices are only part of the story. Proactive CFOs establish a top class performance measurement system in the company, and keep their ears and eyes open for experiences across sectors and countries.

Corporate strategy has its roots in various functions. The action points are therefore spread throughout the organization. CEOs need support in monitoring the implementation of strategy. Generally, the 'Office of the CEO' or 'Corporate Center' offers this support. Wherever such positions do not exist, the mantle falls on the CFO. "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.[7]

The beauty of a rose is in its physical form - the same cannot be captured in its price

CFOs however need to avoid the trap of seeking to monetise every value creation activity. The beauty of a rose is in its physical form – the same cannot be captured in its price. The utility of an equity share is however in the value it represents – not the physical paper on which it is printed. CFOs need to have a sense of where physical (operating) measures are useful, and where financial measures are preferable.

CFOs who develop a sound value chain competency can perform a key role in setting the strategic direction of the company – and changing its course from time to time.

The risk competency

For decades, Indian companies did not worry about risk. Whatever they manufactured could be sold for a profit. The only worry was whether the business would generate enough to repay lenders. Capital structure decisions were based, not on business imperatives, but thumb-rules of 2:1 for most projects, going up to 5:1 for capital intensive projects. As far as risk was concerned, ignorance was bliss!

The concept of risk has hit businesses hard. Risks can be *insurable* (mostly related to property, key man and loss of profits) or *non-insurable* (commercial risks such as market, technology, information, credit, litigation, regulatory etc.). Insurance comes at a price. The CFO needs to take a call on whether to bear the price or bear the insurable risk. Non-insurable risks need to be balanced against the return dynamics, to assess the risk-return equation.

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[7] Sundar Sankaran, "CFOs: Changing Role", Chartered Financial Analyst, pp 8-16, December 2002

Most sports that are played by individuals (tennis, badminton, carom, squash etc.) operate on a zero-sum mode. There will be a winner and loser at the end of the game. Chess is different because it gives the players the option to take stock of their positions on the board and choose to continue playing (zero sum) or offer a draw (sharing points). This additional 'degree of freedom', as any chess player would vouch, complicates the decision tree by several degrees.

Like a chess grandmaster, the CEO has to take a call on whether to go ahead and play the game with its non-insurable risks, or let some one else take the lead and wait for the risk-return scenario to get clearer, or share the points with a competitor ('co-opetition' discussed earlier). The CFO needs to evaluate the risks inherent in these options.

> As uncertainties increase game theory, Black Scholes option pricing models etc are emerging as useful tools to assist decision making

For a long time, the evaluation in such decision situations was restricted to 'expected values'. Thus, if there is a 40% chance of making Rs10crore and a 60% chance of losing Rs3crore, the expected value is (Rs10cr X 40%) plus (-Rs3crore X 60%) i.e. Rs2.2crore. As uncertainties in the environment increase, game theory, Black Scholes option pricing models etc. are emerging as useful tools to assist decision making.

Cephalon Inc., a biotech firm, bought a large block of call options on its own stock. If the FDA approved the firm's new drug, the firm would have large cash needs, which the options were designed to meet. This is a novel use of equity derivatives as a cash-flow hedging strategy.[8]

According to a poll conducted by Prof. John Graham of Duke University, over 27 per cent of the respondents from 4,000 US companies had used Real Options Analysis for at least one major investment decision.[9]

The major integrated companies (Exxon, Mobil, British Petroleum, Shell, and Texaco) were among the first to use real options – for exploration and production decisions and to bid on offshore leases… Pharmaceutical companies such as Merck are using real options to evaluate and manage research and development programs.[10]

As the risks of doing business increase, the CFO would be expected to view risk-return dynamics through such theoretically sound models.

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[8] George Chacko, Peter Tufano and Geoffrey Verter, "Cephalon Inc.: Taking Risk Management Theory Seriously", Harvard Business School Working Paper, Feb 25, 2000

[9] Journal of Financial Economics, March 2002

[10] Tom Copeland, "Getting Real", Corporate Dossier, The Economic Times, December 6, 2002

The stakeholder expectations competency

The corporate structure of doing business was originally conceived to serve all stakeholders. This included shareholders, employees, customers, suppliers, government and society. In the days ahead, we can expect greater balance in the contribution of companies to different stakeholders. The trend in corporate governance regulation worldwide is to use the framework of *independent directors* to ensure such balance.

'*Stakeholder balance frameworks*' will be based on welfare economics, ethics and philosophy

Independent directors cannot perform this role merely by attending meetings of the board or its committees. I expect the academic community and consultants to generate frameworks (variants of the balanced scorecard with some lateral thinking on measurement of contribution) that would help independent directors catalyse a balance across stakeholders. This new set of frameworks (let us call them '*stakeholder balance frameworks*') will be based on welfare economics, ethics and philosophy. They will require extensive information support from the company. Who else will provide the information, but the CFO?

Thus, the CFO is poised to assume a new role in customising the stakeholder balance frameworks to meet individual company situations, and populating them with information. The information flows here would be different from the support that the CFO provides for strategy formulation and implementation – because the focus would not be on the business model, but on the stakeholders. It is likely to be a mix of external and internal information, many of which are currently not part of the formal reporting systems of companies.

The CFO's role in resource mobilization and value maximization brings her in close contact with one of the stakeholders viz. the shareholder. Since the equity flows cannot be entirely delinked from control, the CFO often ends up in conflicts of interest – between what is good for the company and what is good for the principal shareholder / CEO. Ideally, the interests of the company and the principal shareholder / CEO should match; but often they don't. The ongoing Grasim – Larsen & Toubro saga, for instance, throws up interesting corporate governance issues for both the acquirer and the management.

Regulations like the Sarbanes-Oxley Act too put the CFO in a situation of having to choose between loyalty to the CEO and loyalty to the shareholders - or to put it differently, between protecting one's job and protecting one's neck.

The CEO / CFO would not mind certifying the *financial accounts,* which are supposed to be prepared in line with standard accounting principles, practices and standards. Unfortunately, in the process of removing subjectivity in financial accounts, financial statements have ceased to reflect the core strengths and assets of companies. Is it time to consider publication of *management accounts*, that have inherent subjectivity, but could report the realities of companies and their position? With loads of subjectivity, can we even consider certification of such *management accounts*?

Is it time to consider publication of *management accounts* that have inherent subjectivity?

I have expressed the view in another article that if the CFO is evaluated based on stock market valuation, he should not have control over the accounting of earnings. "Transfer of accounting and audit responsibility to an independent 'Compliances and 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.[11]

I fear that corporate structures have not kept pace with some of the environmental changes that have increased the responsibilities of the CFO. As of now, the CFOs are in an unenviable position of having to address several conflicts. The choices are not easy. Therefore, the CFO requires not only outstanding professional capabilities and high ethical standards, but also strong survival instincts.

CFOs' tryst with destiny

It is clear that regulatory and business expectations from CFOs have increased. Every CFO needs to ask herself how well equipped she is to excel on these expectations. What effort is she taking to meet skill shortfalls? This will determine whether she becomes an *Accountant CFO* immersed in the books of accounts, or a *Traditional CFO* adept at handling the traditional roles or a *Super CFO* holding center-stage in the organization.

[11] Sundar Sankaran, "CFOs: Changing Role", Chartered Financial Analyst, pp 8-16, December 2002