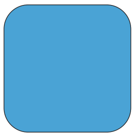

IS IT THE END OF CHIEF FINANCE OFFICERS?

Managing cash flow is a very different issue from managing book value — and clearly one of critical importance.

PAUL BARNETT

A few weeks ago I wrote a short article for my daily Strategy Snack email subscribers.[1] As usual, it had a deliberately provocative title and content that was thought-provoking — and it was designed to promote discussion in our forum. It hit a raw nerve with some readers, but it really resonated with most commentators. One of the readers, Morgen Witzel (editor of the publication you are now reading), invited me to expand on the original article and produce a feature-length version; here it is. It starts in pretty much the same way, but I have elaborated on many issues, and I have added several others.

Recently I spotted a job vacancy for a "chief resource officer," which intrigued me. I was even more intrigued by the job description:

> This is not just a finance role. The Director of Resources will play a crucial role in helping [the company] achieve its ambitions. This is a wide brief, encompassing finance, estates, and IT. You will obviously ensure that a rolling quarterly forecast and other financial information is delivered accurately and on time. However the role is also a conduit of support, helping colleagues recognise the story that financial data communicates. And as a critical member of the senior team, you will be involved in all the strategic decisions.

Other parts of the job description added: "You will be strategic and solutions-orientated, appreciating the business partnership approach to work and recognise that you are there to service the rest of the organisation," and "With strong leadership and an ability to get on with all people, you will be enthused...to deliver the best outcomes."

Some may argue that several aspects of this job description cover the role that the chief finance officer (CFO) should perform, and I would agree. But in practice I think the number of CFOs who act as "a conduit of support, helping colleagues recognise the story that financial data communicates," for example, are few and far between. Indeed,

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most are not capable of ensuring, or are unwilling to ensure, that the board understands the story — or so it would seem — and herein lies a whole host of issues, such as the rightful future role of the CFO, the training that CFOs have had and should get, whether the mindset of finance and accounting professionals is appropriate, and so on.

Before talking about the role of the CFO further, I want to deal with some really important issues, such as the widely accepted view that up to 80 percent of the value of businesses is said to be in the intangible assets (brand and reputation, people and their capabilities, company knowledge and "know how" — particularly relating to the ability to innovate — and so on). The finance professions have so far failed to determine satisfactory methods of accounting for even their present values in financial terms when they need to, and they seem even further away from being able to agree to standards for measuring the intangible (nonfinancial) indicators of the future value of a business. For example, recent research by KPMG found that while 56 percent of audit committees name customer focus as a top three value driver, only 7 percent of companies provided performance data on customer focus or satisfaction[2] — and what standards are there for measuring and reporting such data anyway?

To put this issue another way, finance might rightly be regarded as a resource, and it is the resource that the finance and accounting professions focus on. Still, it is only one of several resources that companies are dependent upon, and increasingly it is not the most important one. Managing cash flow is a very different issue from managing book value — and clearly one of critical importance.

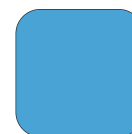
This point is made even more powerfully in a recent article in *Harvard Business Review* by two Harvard Business School professors. They note that the finance and accounting professions, including investors of all types, are relying on metrics that are based on the outdated assumption that capital is a scarce resource, when it is in fact in "superabundance," as Bain and Company puts it.[3]

The Harvard professors, Clayton M Christensen and Derek van Bever, talk of the "unexamined economic assumption."

> The assumption, which has risen to almost the level of a religion, is that corporate performance should be focused on, and measured by, how efficiently capital is used.[4]

The point I want to make here is that if capital is not scarce — and is therefore not the scarcest and most valuable asset in the business — focusing on it, as the investors and accounting professions do, is at best misguided and misleading and at worst dangerous. Attention should instead be paid to the way in which management enhances the value of all capitals over time.

To talk of danger is not an exaggeration. Christensen and van Bever note that ratios such as ROCE, simply fractions comprising a numerator and a denominator, could be driven by generating more profit to add to the numerator, "but if that seemed daunting they [CEOs] could focus on reducing the denominator — outsourcing more, wiping more assets off the balance sheet."[5] And, either way, the ratio would improve. "Similarly, they could increase the IRR [internal rate of return] either by generating more profit to grow the numerator or by reducing the denominator — which is essentially the time required to get the return. If they invested only in projects that paid off quickly, then IRR would go up."[6]



ATTENTION SHOULD BE PAID TO THE WAY IN WHICH MANAGEMENT ENHANCES THE VALUE OF ALL CAPITALS OVER TIME.

We know that this happens, and we know that focusing on financial performance to achieve quarterly reporting targets the long-term health of the firm and the value it can generate, both of which are likely to be damaged or destroyed as a result. This has been well-documented in the Kay Review, which references the failings of the U.K. equity market.[7] There is also real evidence that these dangers play out in reality. A survey of more than 400 financial executives found that 80 percent would decrease discretionary spending on R&D, advertising, and maintenance to meet short-term earnings targets.[8] More than 50 percent say they would delay new pro-

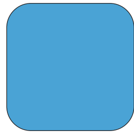
jects, even if it were to mean sacrifices in value creation.

Such actions (often supported by CEOs who are, as we frequently hear, incentivised to achieve quarterly results) have a negative impact on the intangible assets, which are the drivers of future performance. They are therefore doing exactly the opposite of maximizing shareholder returns — they are destroying them. To me this is a clear demonstration that neither accountants nor analysts or investors are given sufficient information about a business and its strategy. Moreover, they are not able to make robust judgments about future value-creating capacities of intangible factors. Hence, they are unable to make good decisions about the allocation of resources, of which capital is but one — and not the most important one in most companies.

Rule of thumb and hurdle rates bear little resemblance to the real cost of capital

If further evidence of this is needed, Christensen and van Bever provide that too. They point out that instead of making real assessments to determine the correct cost of capital, they use *rules of thumb* and what they call *hurdle rates* of interest — both of which are artificially high and bear little relation to the almost zero rates of interest offered by many central banks these days. In fact they are used as substitutes for risk-adjusting cash flows. The authors even illustrate the size of the gap:

> Entrepreneurs claim in their business plans that investors will make their money back five times over. Venture capitalists ask for even higher returns, and internal corporate business plans routinely promise returns of from 20 percent to 25 percent, because that has historically been regarded as the corporate cost of capital.[9]



POOR INVESTMENT DECISIONS ARE MADE AND LONG-TERM VALUE IS EITHER BEING DESTROYED OR NOT BEING CREATED.

Of course, it is in the interest of the venture capitalist to negotiate the highest rate possible anyway.

As they note, "hurdle rates aren't handed down by a deity; they can (and should) be changed as the cost of capital changes." I suggest that this does not happen because such rules of thumb provide a large enough margin of error to compensate for the inability of analysts and investors to more accurately predict their likely returns on investment based on any real indicators (i.e., the intangible factors). I say "a large enough margin," but even that is not always the case. Evidence suggests that most investments underperform the expectation published in a prospectus.

To be fair, part of the inability comes from insufficient training and part comes from the inability or unwillingness of companies to provide the necessary information in sufficient quantity, quality, or detail, together with coherent narratives to explain the numbers. The latter is the case for businesses of all sizes — listed companies and their annual reports or unlisted companies and their business plans.

Investors and investees lose, and capitalism is less efficient than it should be

The result of this situation is that both investors and investees lose, and capitalism is less efficient than it should be. Companies pay a high price for the investments they need. Poor investment decisions are made and long-term value is either being destroyed or not being created. In another article I wrote recently, I asked: What is the value in strategic business reporting? I argued that "the strategic importance and value of both corporate reporting and management reporting is seriously neglected,"[10] partly because the neglect does not result in a loss, but rather in value not added.

To illustrate my point, I referred to an article in *The Hollywood Reporter*. It reported that Warren Buffett, the "notoriously low-tech billionaire," disclosed that through his Berkshire Hathaway fund he had invested $10.7 billion into IBM since March of that year (a stake of 5.4 percent). Giving his reasons, he said: "I don't think there's any company that I can think of... that's done a better job of laying out where they're going to go and then having gone there." He continued: "They have laid out a road map and I should have paid more attention

to it five years ago — where they were going to go in five years ending in 2010. Now they've laid out another road map for 2015."[11]

So strategic business reporting, clearly laying out the road map, paid off to the tune of $10.7 billion for IBM.

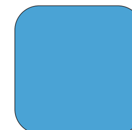
How many companies are forgoing investment they might otherwise get, and how many are paying a high cost of capital?

With not a single mention of the moves toward more integrated reporting (see the following text), one of the conclusions that Christensen and van Bever come to is that "we need new tools for managing the resources that are scarce and costly, not finance, but the intangible assets."[12] They also mention that "we need new ways to assess investments." The big question is, where will the new tools come from — from finance and accounting or not? At this stage it is impossible to be certain, but many inside and outside the world of finance and accounting believe the answers will not all come from only one source.

For some time now I have been considering the link between strategy and integrated reporting, concepts promoted by the likes of the International Integrated Reporting Council (IIRC).[13] These initiatives focus on the failings of the accounting profession to adequately measure, understand, and predict the future value-generating capacity of the intangible assets in a business. It was this that led me to ask: If accounting is unable to account for the current and likely future value of the business, and if the CFO is to focus on only short-term value, are the days of the CFO numbered? And should they be?

So far I have come to no conclusion other than this: Solving the problem is an urgent challenge and one that the finance and accounting professions are unlikely to solve alone. But they certainly need to make the first steps — and that means taking a position that says long-term stakeholder value is the right measure of business performance, and shareholder value maximization should not be the driver, but the product. It also means stating clearly that quarterly reporting should be abandoned. Furthermore, it means that the accounting profession needs to help develop widely accepted standards for the measurement of the intangible assets and how they have been enhanced over time — but not in financial value terms. Just as importantly, it must be recognized that standards need to be applied in a customized way for each company, relating to that company's particular business model, for them to be relevant and meaningful.

In my original article I said that "the day when the accounting profession and CFOs are capable of the tasks seems a long way off. There are real practical difficulties, but the biggest obstacle may be the mind-set. It is for this reason I suggest the days of the CFO may be numbered and the role of the Chief Resource Officer (CRO) may be the 'medicine' that is needed."[14] I was referring to the job description I described at the start of this article.



THE ACCOUNTING PROFESSION NEEDS TO HELP DEVELOP WIDELY ACCEPTED STANDARDS FOR THE MEASUREMENT OF THE INTANGIBLE ASSETS AND HOW THEY HAVE BEEN ENHANCED OVER TIME — BUT NOT IN FINANCIAL VALUE TERMS.

The CFOs should not necessarily own integrated reporting

Those who commented on my article included Stathis Gould, Head of Professional Accountants in Business Service Delivery at the International Federation of Accountants (IFAC), who said: "The CFOs should not necessarily own Integrated Reporting, but they can foster the holistic view of the organisation that is needed from a governance, people, process and systems point of view." I would agree, but I would also add that so can other functions. Interestingly, one commentator on my initial article said he felt that the role of the CFO was becoming "all-encompassing" and it should not be. Others made similar remarks and added that they felt the solution should come from "advancing holistic thinking in the C-suite."

The conclusion I am hearing, and that I have started to come to myself, is that the role is more important than the title of the person who performs it. At the same time, while the role is important, in most companies it is not being performed well, perhaps because it is already

not clear who has the role and responsibility of the management and accounting for nonfinancial resources.

The author of one comment on my original article made the very pragmatic observation that "what is important is that the person actually doing the job is capable and that the buck stops with the right person (the CEO)…I guess there is one other option, which would be a management team approach which largely ignores management silos and simply allocates tasks and responsibilities according to various management team member capabilities."

Along these lines, a different commentator introduced the concept of stakeholder alignment councils, which he had established for clients with the aim of "helping to align the organisation toward common objectives, including resource utilisation, staffing, training, etc."

The importance of the ability to effectively manage all resources has been highlighted by Rita McGrath as a key difference between those companies that thrive and those that dive, in an era she describes as being one of *transient advantage* (rather than *sustainable competitive advantage*).[15] In short, firms built to thrive under transient advantage conditions handle resources differently than firms designed for exploitation. McKinsey made the same argument in a slightly different way, saying: "Put your *money* where your strategy is," which should have been: "Put your *resources* where your strategy is."[16] But, in another indication of the failings of the accounting profession (assuming the CFO's job is considered to include advising the CEO and/or board on such matters), the article said that "most companies allocate the same resources to the same business units year after year. That makes it difficult to realise strategic goals and undermines performance. Here's how to overcome inertia." In an era of increasingly transient advantage, it is imperative that companies get smart in thinking strategically about all resources — not just the finances — and are capable of managing them (and the interdependencies between them) in a dynamic way, with the aim of long-term value creation for all stakeholders.

IN AN ERA OF INCREASINGLY TRANSIENT ADVANTAGE, IT IS IMPERATIVE THAT COMPANIES GET SMART IN THINKING STRATEGICALLY ABOUT ALL RESOURCES — NOT JUST THE FINANCES — AND ARE CAPABLE OF MANAGING THEM (AND THE INTERDEPENDENCIES BETWEEN THEM) IN A DYNAMIC WAY, WITH THE AIM OF LONG-TERM VALUE CREATION FOR ALL STAKEHOLDERS.

In this article I have been highly critical of the CFO and the accounting and finance professions, but I think I can get away with that because I know many people within the professions who share a number of the concerns I am expressing and are trying to grapple with several of the issues. Still, I would not want you to think that I direct all of the blame in one direction only. I have already mentioned the inability or unwillingness of companies to report well, the issue of short-termism being fuelled by bad incentives, both criticisms that directors must address.

Another problem that exists is one that must be addressed by all professions, by companies (and the way they are structured), and by business schools (and the way they teach). This is the problem of management by functional silos. I refer again to Christensen and van Bever. They note that business schools, including the one at which they teach, "have routinely separated disciplines that can only properly be understood in terms of their interactions with one another, and we've advanced success metrics that are at best superficial and at worst harmful." They add: "Finance is taught independently in most business schools. Strategy is taught independently, too — as if strategy could be conceived and implemented without finance." They also add that "the intricate workings of the resource allocation process often are not studied at all in business schools." They conclude that "since the functions of the enterprise are interdependent, we should mirror this in our teaching."[17]

Finance and strategy are taught independently — As if strategy could be conceived and implemented without finance

This recognition has been a long time coming and will take a long time to filter through into businesses. In the meantime, businesses might take something from the admission of the failures of business schools to work out how to

break down management silos and to ensure management is a collaborative process — perhaps by adopting the concept of stakeholder alignment councils described previously.

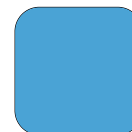
Earlier I quoted the McKinsey comment that reads: "Put your money where your strategy is" and suggested it should instead read: "Put your resources where your strategy is." I also referred to McGrath's observation that those companies that thrive when advantage is only ever transient manage their resources differently. I am repeating these two points to make another important point and emphasize a few statements. The point I want to make is that I would be very surprised if those making judgments about the value-generating capacity of a business (investors) are taking full account of the risks associated with the fact that we live in a world of increasingly transient advantage — and we are probably assuming that it is far less volatile and uncertain than is the case.

The related statements I want to make are:

1. The reasons why advantage is only transient are intensifying.
2. Capital is likely to remain abundant, so it is not a scarce resource.
3. Innovation and knowledge will be the real drivers of competitive advantage, so the value of intangible assets will remain high.
4. The ability to manage intangible assets will therefore be the best indicator of future value.
5. Investors will eventually wake up and realize this.
6. If traditional sources of finance do not realize this and lower their cost of capital, new financial providers will emerge (and this is already starting to happen). This could be positive for companies that understand a more complex marketplace for capital, but it adds to complexity and it may clearly impact the traditional capital providers in a negative way.
7. Being able to produce integrated management reports will be recognized as being strategically important, but not for the reasons one might think.

This last point is one I need to explain: The biggest benefits of integrated reporting will not come from being compliant or from attracting investors. They will come from the discipline of needing to think, plan, and manage in a more integrated way. This will help companies achieve the agility and flexibility they need to respond to change — and seize opportunities — in an increasingly transient world. However, smart investors will also recognize this.

My final point relates to a claim I made in a Strategy Snack some time ago: I foresee that every business will need to be a social enterprise. You might think this is an exaggeration, but let me say that nearly every large multinational entity is already beginning to recognize that bigger considerations, including maximizing stakeholder values, are the ways that shareholder returns will also be maximized over the long term. Many of those entities have launched social enterprise projects. Others are finding that their customers expect far more of them as "corporate citizens." Through sustainability initiatives, they — like charities — are having to measure and report about more than just profit. They struggle to find the "new metrics" by which to report their performances in these areas. But they are not waiting for the accounting profession to provide the answers. ■



CAPITAL IS LIKELY TO REMAIN ABUNDANT, SO IT IS NOT A SCARCE RESOURCE. INNOVATION AND KNOWLEDGE WILL BE THE REAL DRIVERS OF COMPETITIVE ADVANTAGE.

NOTES

1 Barnett, P., "Is it the End For Chief Finance Officers?" (April 5, 2014). Available at: https://www.linkedin.com/today/post/article/20140405150042-190861715-the-it-the-end-for-chief-finance-officers?trk=mp-reader-card.

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[12] *Op. cit.* note 4.

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[15] McGrath, R.G., *The End of Sustainable Competitive Advantage: How to Keep Your Strategy Moving as Fast as Your Business.* (Harvard Business Review Press, 2013).

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[17] *Op. cit.* note 4.