White paper
The Role of Finance in the New Management Model

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About Beyond Budgeting Institute

The Beyond Budgeting Institute is at the heart of a movement that is searching for ways to build lean, adaptive and ethical enterprises that can sustain superior competitive performance. We promote a set of principles that lead to more dynamic processes and front-line accountability. Organisations that follow this approach transform their management model in line with these principles.

Our ideas are spread through the Beyond Budgeting Round Table (BBRT); a shared learning network of member organisations with a common interest in transforming their management models to enable sustained, superior performance. We help organisations learn from worldwide best practice studies and encourage them to share information and experiences to move beyond command and control.

Through Beyond Budgeting Advisory (BBA) - our consulting practice - we help organisations with the practical implementation of new management models inspired by the Beyond Budgeting principles. We refer to this as being on a Beyond Budgeting journey. This implies an ongoing effort of continuous learning and improvement, rather than a project with an end date.

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Introduction
There is a healthy tension at the apex of most large organisations between the CEO and CFO. The typical CEO wants to exceed shareholder expectations by driving top-line growth, launching innovative products and business models, adapting rapidly to a changing environment and of course producing better share-holder returns than their peers. He wants to unleash ambition and encourage risk taking while hacking away at costs. He is prepared to trust people to make the right decisions provided they are accountable for results. And he wants to be seen as a supporter of sustainability while not compromising bottom line profit. While the CFO might agree with this vision, she is more sceptical about its execution. In her mind words such as ambition, innovation, growth, trust and sustainability spell one word: risk. The fear of losing control is her recurring nightmare. That’s why she is more comfortable maintaining tight control over spending and investment strategies. She wants to bind managers to short-term performance contracts and tie them to detailed cost budgets. And she sees opportunities in IT systems and tools to further improve efficiency and effectiveness. While the CEO is the accelerator, the CFO is the brake.

This balancing act between optimism and realism, innovation and efficiency, growth and caution, trust and control, sustainable investment and short-term profit is played out at countless board meetings in every organisation across the world. While this has been the case for decades, CEOs don’t need much convincing that the balance is tilting decisively toward innovation, growth and sustainability. Most believe that efficiency gains have run their course and that top-line (organic and profitable) growth is now the priority. In a recent IBM study, 65 per cent of the world’s top corporate CEOs declared that due to pressures from competitive and market forces, they plan to radically change their companies in the next two years. CEO of General Electric Jeff Immelt said in a 2006 interview that he aims to grow his organisation two to three times faster than world GDP (that’s around 8 per cent a year) and that the company is working on developing a “growth process” for achieving this. “We have to change the company – to become more innovation driven – in order to deal with the new environment,” noted Immelt.

How should CEOs and CFOs respond? While many management writers and consultants would recommend beefing up the R&D department, designing new ‘approval’ processes to ensure that all worthwhile projects are funded, implementing tools such as the balanced scorecard to better align new initiatives with strategy, and tinkering with incentive schemes to attract people’s attention, few leaders are prepared to face the brutal reality – they have the wrong performance management systems (how goals are set, how the strategy, execution and control processes are managed, how managers obtain funding for new projects, and how people are evaluated and rewarded).

The truth is that the vast majority of these models and systems are relics from the industrial age. They were designed for command and control rather than innovation and sustainability. And despite implementing a range of new tools and techniques, these models and systems haven’t changed. Command and control, contract and compliance, central planning and top-down control, ‘meet the numbers or else’ – these are still the words that best describe most performance management systems today. To place innovation and sustainability at the top of the agenda will mean rethinking and replacing many management theories and practices accepted today as ‘conventional wisdom’ such as agency theory, transaction cost economics, economies of scale, hierarchy, strategic planning, budgeting, and extrinsic (individual) rewards.

The work of the Beyond Budgeting Round Table (BBRT) over the past ten years has focused on these problems and its members have been working together to design a management model more appropriate
to the twenty-first century organisation. It has produced dozens of case studies as well as white papers, diagnostics, CFO interviews and books on this subject as well as supported many transformation programs. “Beyond budgeting” is about much more than just budgeting. It’s about the whole performance management model from strategy, target-setting, planning, resource management, coordination, performance measurement and control, and even includes management reward systems. And it’s about designing these processes in ways that drive the right management thinking and behaviour – from fast response and stretch goals to innovative plans and lean thinking – while encouraging ethical behaviour and maintaining great controls.

But it crucially depends on an enlightened CFO who recognises the problems caused by outdated systems and why these need to change to support the critical success factors of the twenty-first century organisation. We in the BBRT have come to realise that, unless the Finance Operation transforms itself (processes and mindsets), then these system and behavioural changes will remain elusive. That’s why our research focus has been extended into the role that Finance can play in enabling these changes. Jeremy Hope’s CFO interview series and his 2006 book “Reinventing the CFO” are outcomes of this research. Steve Player has added to this knowledge base with his articles for Business Performance Magazine that, again, involved many CFO interviews.

This paper focuses on how Finance needs to be transformed to support the new management model. This is a tough task given that the pressures on Finance today are intense. From IFRS, cost reduction pressures through benchmarking, finding and keeping talented people, constant reorganisations, keeping the CEO and CFO out of jail, and providing business colleagues with fast, relevant information as well as more analysis and insight, the challenges are tough and getting tougher. While they aspire to be business partners, their departments have shrunk over the past ten years from around 3 per cent to 1 per cent of revenue – world-class organisations are around 0.6 per cent – and their people are stretched to breaking point. This means that they continue to struggle with the basic accounting tasks. Over two-thirds of their time is spent on transaction processing and month-end routines. There are simply too many journals, too many spreadsheets, too many errors, and too many disconnected systems. Budgeting takes too long, is too expensive, and adds too little value. In addition, there are too many irrelevant measures and reports, information flow is way too slow and forecasting and risk management are not core competencies. The result of all these failings is increasing levels of detail and complexity and less space and time to add value.

But perhaps the most acute challenge is keeping the best people. The talent pool is shallow and the best people are likely to be on someone else’s target list. The answer is of course to ensure they are well paid. But even that is unlikely to stop them leaving. The real answer is to give them stimulating work that develops their experience and enables them to satisfy the needs of internal customers (or business partners). Deep satisfaction linked to competitive compensation is what keeps people coming to work every day.

Despite this gloomy picture, there are many examples of CFOs who have made a real difference to the success of their organisations. These executives have built highly competent teams that satisfy the needs of their management colleagues in a consistent and uncomplicated way. While recognised as an integral member of the strategic management team, they maintain a strong, independent view and oversee effective internal controls and risk management systems. But, perhaps above all, they have time to spend with their staff and with important stakeholders including non-executive directors and investment analysts.
One shining example is American Express. Finance and IT have worked together to deliver shared services with huge cost reductions, a streamlined planning process with an emphasis on driver-based rolling forecasts, and an investment optimisation process that lets senior managers prioritise new investments on a monthly basis. The result is less gaming of resource requirements, more accountability for funds, and better alignment of measures and actions with strategy. They’ve built an organisation that has improved to such an extent over recent years that it now has one of the highest price/earnings ratio in its industry sector.

Many other organisations (see figure 1) have moved significantly along the road to transforming their finance operations and in some cases the whole culture of the organisation. You will notice the diverse range of industries, countries and cultures. You will also notice the consistently high performers amongst them. Handelsbanken, Toyota, Southwest Airlines, GE Capital, IKEA, American Express, UBS and Wachovia are all either at or near the top of their industry peer groups all of the time.

What can Finance learn from these exemplars and what steps do they need to take to become a world class team and valued business partner? There are six important steps: create more time (and reduce costs), improve capability, support business agility, reduce waste, support a high-performance culture and become a business partner (see figure 2).

1. Create more time and reduce costs

The first step in the transformation program is to create more time and reduce costs by eliminating unnecessary work and streamlining (and if necessary, outsourcing) financial processes. But the major change (many have tried to achieve this already) is to implement enterprise-wide transaction processing systems that require minimal manual intervention. An increasing focus on web-enabled technology is undoubtedly the future for transaction processing work. The fewer the manual hand-offs, the less likelihood there is for errors and re-work and the lower will be the costs. Mapping key processes such as purchase-to-pay,
order-to-cash, and inventory management) and relentlessly improving them by eliminating unnecessary steps and delays and improving quality is another essential step. These back-office processes should be centralised and standardised. Only if managers find this too difficult should they resort to outsourcing. American Express was able to cut $200 million from its cost base by centralising and standardising key processes.

One of the first tasks is to liberate both Finance and business managers from huge amounts of detail and the proliferation of complex systems that increase their workload and deny them time for reflection and analysis. This means purging their systems, measures and reports and eradicating work that adds little value (e.g. detailed planning processes, redundant systems and irrelevant reports). It also means being more wary of implementing new tools and IT systems that soak up valuable time and money but fail to provide reasonable value. Creating space and time for higher value work is the crucial step that turns transformation rhetoric into practical reality.

Reducing the time and cost of the month-end close is another worthwhile objective. Significant time is taken up with the month-end close (over 10 days each month for many organisations). This should be reduced to 2-4 days by making every effort to reduce complexity in the accounting system (Finance needs to persuade senior executives to streamline the corporate structure and reduce management and systems complexity); preparing a “process map” of the close process and eliminating any time delays (e.g. reconciliations, accruals, timesheets, journals); and ensuring that all charts of account are standardised.

‘Dirty data’ is another problem, yet most executives are oblivious to the data quality problems that lead to the slow but steady erosion of an organisation’s credibility among customers and suppliers, as well as its inability to make sound decisions based on accurate information. And, of course, there are huge problems to deal with around compliance with Sarbanes-Oxley and other regulations. Cleaning up financial and documentation audit trails is a key priority.

Figure 2: The roadmap for change

How to become a world class finance team and valued business partner

- Create time/cut costs
- Improve capability
- Support business agility
- Reduce waste
- Support a high performance culture
- Become a business partner
2. Improve capability

Breaking free from detail and complexity and stabilising processes creates time for Finance to improve their skills and provide the information that managers need to make effective decisions. But that alone is insufficient to build a credible Finance team that will be seen by managers as a trusted and valued business partner. The CFO must also work hard to attract and keep the best people and build the right team. These are people who know the business, can achieve high levels of analytical skills and be able to contribute with improvement ideas. They will also be able to communicate effectively and work in teams. They need to become teachers and mentors as they spread financial knowledge and decision-making capabilities across the organisation. Providing three career tracks (technical, cross-operational and shared services) will help CFOs to build the right team and give their people the rounded experience they need. Organisations such as General Electric and American Express offer highly rated management development programs for their Finance staff. These programs are aimed at providing all-round experience and building relationships across the organisation that ultimately lead to credible business partners.

3. Support business agility

Managers will only feel truly liberated if the CFO can release them from the chains of the detailed annual planning cycle and replace targets and budgets with more effective steering mechanisms. This is one of the CFO’s greatest challenges. While many leaders are trying to drag their organisations (often kicking and screaming) into the innovation economy, they are faced with the insurmountable barriers of the management factory whose barricades are manned by some of the most powerful vested interests in the firm (see figure 3). This leads to a collision of cultures as the new world of horizontal processes and self-managed teams meets the old world of vertical reporting and line management.

Figure 3: Abolish the management factory and integrate information with the work
The battleground is often concerned with openness and transparency of information as the old controllers continue to deny self-managed teams access to the knowledge they need to make decisions.

Annual fixed targets and budget contracts reinforced by incentives are the traditional tools of the management factory. They are based on the concept of ‘predict and control’. But this concept is no longer valid (if it ever was) in a world of rapid innovation and discontinuous change. Why do recent additions to the management factory such as balanced scorecards, customer relationship management systems, quality systems (such as ISO9000) and benchmarking so often fail to meet expectations? After all, each of these tools and techniques is based on a good idea. Who would argue with using more balanced measures, enhancing customer relationships, improving quality and comparing performance with peers? The problem is that they lose their value in the way they are implemented. Because they are acquired and implemented by staffers employed by the management factory, they are inevitably seen as more top-down control systems supported by manuals, training courses, reporting deadlines and performance reviews. There is little or no ownership at the local level. The result is that these tools collide rather than connect with self-managed teams and are the nemesis of the innovative and adaptive organisation. That’s why some CFOs are dismantling the management factory. Their new focus is on liberating front line teams and fostering self-regulation and collaboration. This is one of the secrets of Toyota’s success and is being copied by many other organisations.

To become a true business partner, Finance managers need to dismantle the old top-down control system of the industrial age. As noted earlier, this system was designed for command and control (and efficiency and effectiveness). It was never designed for empowered teams to respond rapidly or to use their knowledge to provide innovative solutions. These will include continuous planning reviews and rolling forecasts that enable managers to sense and respond more rapidly to unpredictable events and to changing markets and customers. The CFO must also be prepared to devolve some planning and decision-making scope and authority to front line teams; otherwise the benefits of faster response will be lost. But controls are not compromised. In fact, they are strengthened as managers use fast actuals, key performance indicators, rolling forecasts, trend analysis, peer-to-peer benchmarks, investment tracking systems and value stream analysis to influence future events rather than dwell on past results.

4. Reduce waste and improve investment management

With more time to add value, the CFO and the Finance team are able to focus on eliminating huge swaths of costs that have remained unchallenged for years. The Finance team must learn and apply the lessons from lean thinking. Most lean initiatives fail because they conflict with traditional measurement approaches. While budgets and accounting results are based on the red boxes on the organisation chart (see figure 3), lean focuses on measuring end-to-end processes as value is tracked across the value stream. This collision of measurement cultures dooms lean to failure. Replacing the management factory will release many “hidden” costs caused by bureaucracy, unnecessary reporting and controls and the frictional costs of working across organisational silos. Instead of tightening deadening control systems, Finance should spend their extra freedom finding out in which business segments (e.g. markets, products, channels, and customers) value is created and destroyed (Pareto’s 80/20 rule applies here – 80 per cent of segments destroy value), and improving investment management.
One key area is to ensure that all projects are necessary and add value. American Express has designed a standard investment proposal/decision process that can be used at all levels of the organisation. This ensures consistency of use and decision-making. Decision-making can then be devolved to local managers through agreed investment decision thresholds. Some organisations are splitting “core” (essential operating costs) from “discretionary” (non-essential) costs (such as some R&D, marketing consulting, maintenance and so on) and holding discretionary costs at a higher management level. Thus, operating managers need to “apply” for this spending through the standard approvals process when needed (even though they can do this themselves). In this way, operating budgets do not become a ‘license to spend’.

5. Build a high-performance culture

How the organisation defines success is the key starting point in creating a high-performance culture. It is also a ‘fault-line’ between the old and new thinking. The board need to be persuaded to reframe success and accountability in terms of relative performance rather than fixed targets (they also need to meet with analysts to explain that while profit estimates can still be given, these will not be fixed commitments - they will ask to be judged on their performance relative to peers). This principle also applies within the organisation (e.g. by plant, branch, country, product group, function, etc.) – the aim is to harness the raw power of peer pressure and drive up average performance.

But breaking free from the old target-setting negotiations and budget-contract culture will not be easy. “If we don’t set targets how do we know they will achieve the numbers we need?” “How do we hold managers accountable?”, says the CEO. “If we don’t have targets how do we know what is expected of us and how will we be rewarded?”, says the manager and salesperson. From both positions, agreed targets provide a contract between two parties (investors and company; senior executives and business managers; managers and salespeople). Almost every organisation operates with targets. They are so ingrained that they are part of today’s conventional management wisdom and are rarely challenged. But they are deeply flawed. They provide the illusion of ‘predict and control’ in a fast changing, highly unpredictable world. They lead to stress and burnout, drain energy and demotivate people, stifle innovation and growth, undermine speed and agility, encourage people to cheat, and result in unhappy customers and under-performing companies.

Another element of a high-performance culture is the rewards system. Finance needs to work closely with HR executives to design a system that fairly rewards teams for improving their performance relative to peers and best practice. They also need to work with HR to agree a new policy on accountability (making every team accountable for improving their relative performance) and to provide a code of ethics that governs decision-making (and make it uncompromising).

6. Become a business partner

The reputation (whether deserved or not) of most Finance operations is one of ‘number cruncher’ or ‘bean counter’. They have failed to build value-adding and trust-based relationships with business partners. To achieve business partner status they must, at the very least, articulate a compelling Finance vision and spell out the deliverables that they believe will meet partners’ needs. They must also overcome
their arrogant image of the “top-down remote controller” and stress their “humility” (being prepared to learn from their partners and understand their problems). They must also prove their accessibility (always available), reliability (always turn up for meetings), and trust (always deliver on promises). And they must agree that the role of Finance is one of independent professional adviser that adds value by challenging strategic options, forecasts, risks, ethics and so on, to arrive at the best decision (acting as a “sceptic” rather than a “cynic”).

Who Finance members report to is also important. Should this be to the local manager or the CFO? The answer is to agree that Finance reports to the team leader (e.g. business unit manager) although the CFO will be responsible for training, development and career planning.

7. The role of benchmarking in Finance transformation

Some CFOs believe that benchmarking against Finance “best practices” is the way forward. While benchmarking can be highly beneficial at the detailed process level (comparing, for example, how many people work in a process or how long it takes and costs), it falls short when looking at the bigger picture. Benchmarking “best practices” usually represents how the top quartile of organisations perform existing processes. There is little recognition of those organisations that have abandoned these processes and done something differently (e.g. abandoned budgeting and performed the old functions of budgeting in new ways).

In other words, benchmarking organisations tend to focus on process inputs rather than a holistic model (the Finance Vision for Change needs to be holistic in that it involves processes, people, systems and mind-sets). As companies like American Express, UBS Wealth Management and Statoil have shown, the BBRT is uniquely set up to enable you to learn from (and occasionally teach) others as we all aim to reinvent the performance management model and the role of Finance.

The CFO and the Finance team need to re-think their systems and their priorities. They have reached a crossroads. One road leads to more complexity and cost (more systems, controls, procedures, projects, etc) and leaves even less time to meet the needs of their internal customers. Worse than this, it means that they will continue to be labelled as “number crunchers”, “bean counters” and “traffic cops” and remain a barrier to change. The other road leads to the liberation of both the Finance team and their internal customers. It means simplifying everything they do. And it means freeing up time to address information needs and spend time with managers helping them to make fast and effective decisions. This is the road to becoming a trusted and valued business partner. It is the rockier road. But it’s the one that CFOs say they want to take (this is backed up by a 2004 survey that showed that 65 per cent of senior Finance executives want to be business partners within two years – more than double where they see themselves today). But it is tough because it challenges many of the Finance team’s accepted practices and systems. Belief, patience and perseverance are all required. But the prize is worth the struggle. It is no coincidence that an efficient and value-adding Finance operation is closely correlated with sustained business success.