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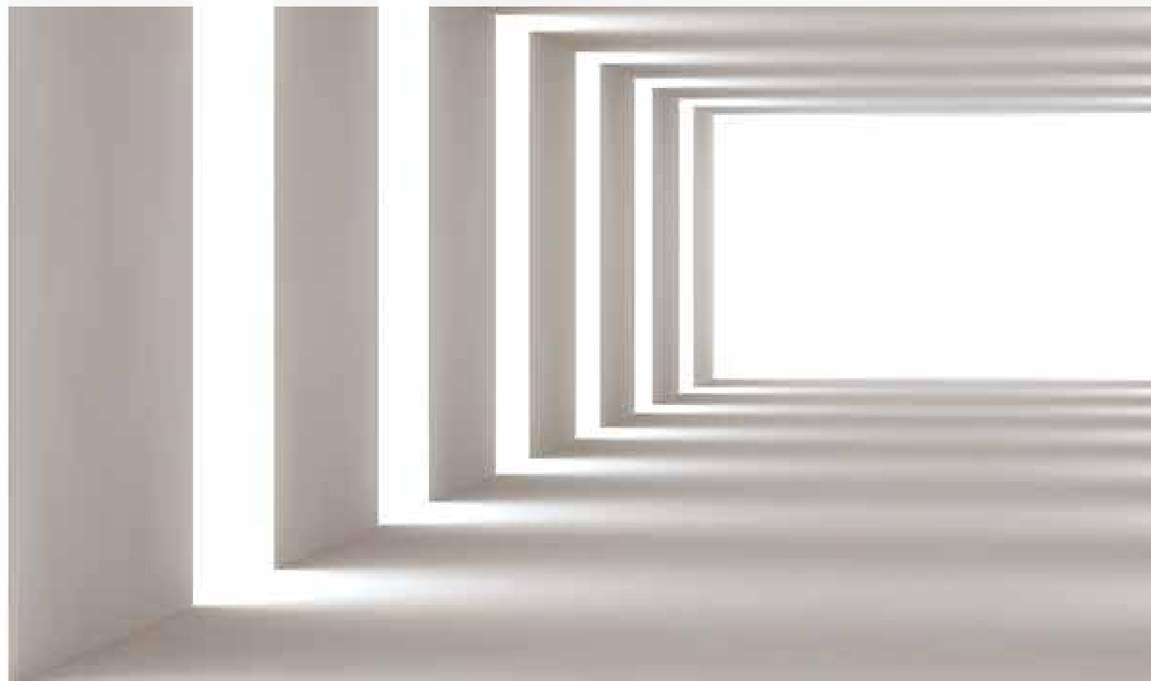

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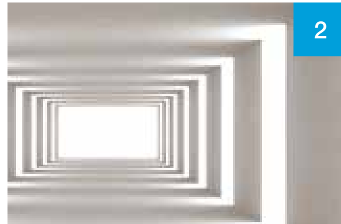
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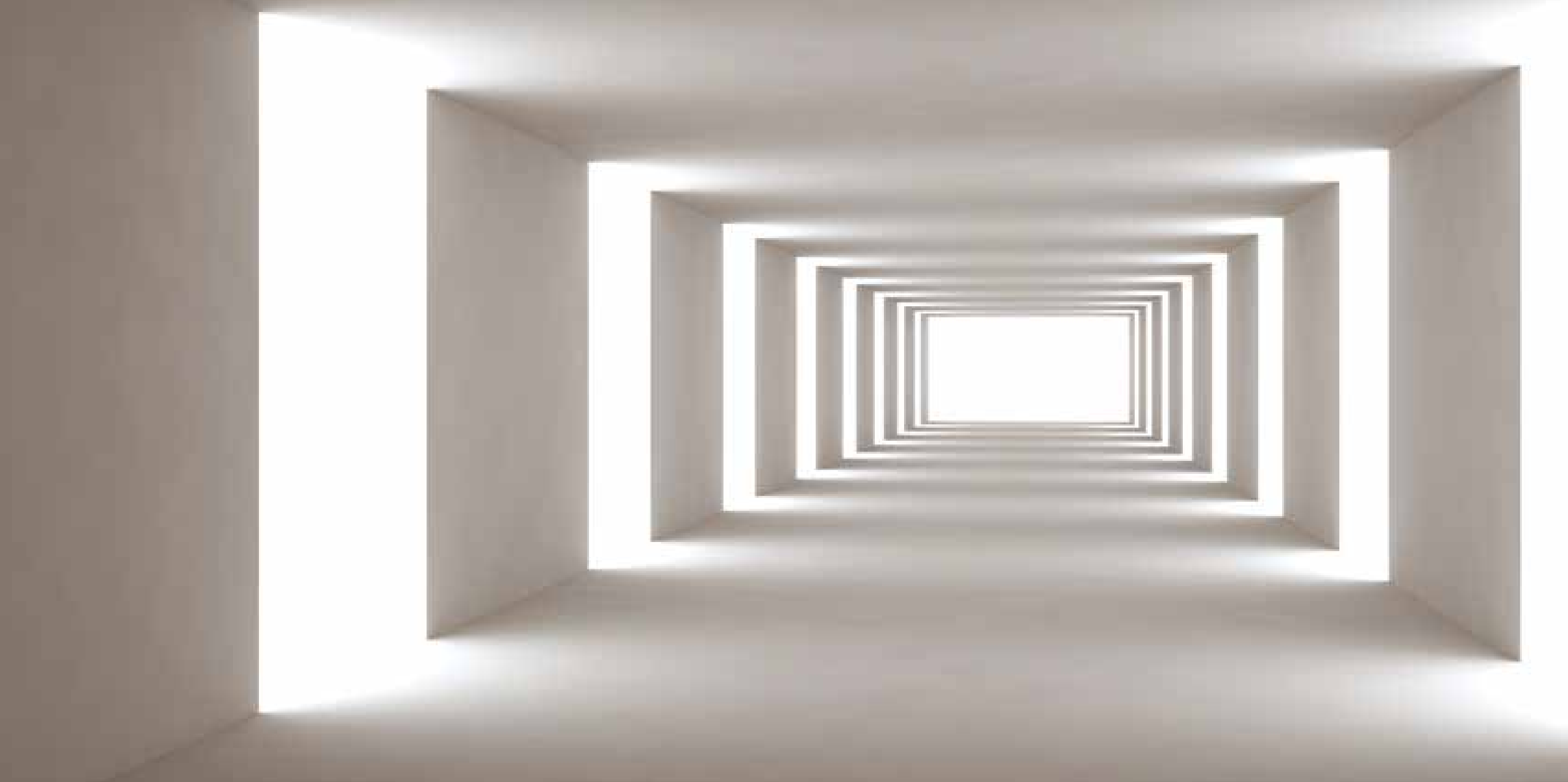

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How to build an alliance against corporate short-termism

Executives have more room than they realize to stand together with sophisticated investors to maintain focus on long-term value creation.

Rebecca Darr and Tim Koller

Public-company managers are quick to bemoan the pressures they face to emphasize short-term financial performance at the expense of long-term value creation. Depending on the day, they point the finger at a range of culprits, including market pressure, economic uncertainty, and investors.[1] But it's time managers took a harder look at themselves and the tools they have to build alliances against the corrosive effects of corporate short-termism.

It is true that short-term investors and their proxies, sell-side analysts, are the most visible participants on quarterly earnings calls and in contacting companies for the insights upon which they trade. The pace and volume of those trades may often dominate a company's daily trading activity. But it's worth recalling that short-term investors are usually a minority of a company's shareholders. Overall, they own only around 25 percent of shares held by US companies (Exhibit 1). In fact, seven in ten shares of US companies are owned by longer-term investors: individuals, index funds, and more sophisticated long-term investors.

As prior McKinsey analysis has shown, this last group, also known as *intrinsic investors*, has an outsize influence on a company's share price over time.[2] With their deep understanding of a company's intrinsic value and their willingness to make large investments,[3] they often see even

bad news, in the short term, as an opportunity to increase their holdings of a company whose strategy and management they support. That gives companies more room than many managers realize to make decisions that create long-term value—even at the risk of short-term volatility. This also benefits all long-term shareholders by keeping share prices in line with a company's intrinsic value and preventing prices from falling too far out of line, relative to the company's peers.

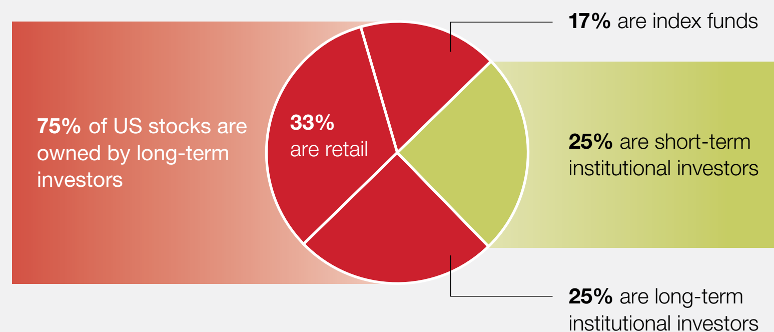
Executives need to understand intrinsic investors better. To begin an ongoing dialogue, McKinsey and the Aspen Institute Business & Society Program[4] convened a group of public-company CFOs and intrinsic investors in late 2014 to discuss their mutual interests. The following year, as discussions continued, we also surveyed and interviewed intrinsic investors, with an average holding period of six years. Our interpretation of these discussions and survey results does not necessarily reflect the views of every participant. But the consensus of the group was that all public-company CEOs, CFOs, and corporate boards should be doing what they can to attract and retain a critical mass of intrinsic investors in order to blunt the effects of short-termism and best support a strategy of long-term value creation.

Our research indicates that four initiatives seem to resonate with intrinsic investors and could prove useful for managers eager to achieve this goal. They include pursuing long-term value creation even at the expense of short-term earnings, proactively structuring investor communications, resisting artificial efforts to meet earnings targets, and rethinking management's approach to quarterly earnings calls.

Pursue long-term value even at the expense of short-term earnings

An overreliance on short-term measures of earnings per share can be a distraction from the long-term trajectory of a company's share price. When asked to react to hypothetical trade-offs between short-term earnings and long-term value creation, past McKinsey surveys have found only half of companies would make

Exhibit 1 **Long-term investors own 75% of US stocks.**



Source: Marshall E. Blume and Donald B. Keim, "Institutional investors and stock market liquidity: Trends and relationships," Wharton School working paper; Thomson Reuters; McKinsey analysis

Intrinsic investors overwhelmingly favor decisions that lead to long-term value creation even at the expense of short-term earnings shortfalls.

an unambiguously long-term decision when confronted with options for a major strategic challenge.[5]

In contrast, intrinsic investors overwhelmingly favor decisions that lead to long-term value creation even at the expense of short-term earnings shortfalls. Consider, for example, an investment scenario that tested investors' support for a range of potential management responses to a major decline in short-term profits, resulting from a large change in foreign-exchange rates. The company, based in the United States, earned 70 percent of its revenues and profits abroad. Nineteen of 24 intrinsic investors in our group[6] said they would be neutral if the company took no action and simply reported lower profits. On the other hand, nearly two-thirds said they would take a negative view of an order for across-the-board cost reductions. Intrinsic investors realize that companies can't control or predict exchange rates and don't want companies to take arbitrary cost-cutting actions to meet current earnings expectations that may hurt the business later.

We then asked, assuming exchange rates stayed the same, whether the company should accelerate cost cutting in the following year to keep its earnings rising, even if long-term revenues could be negatively affected; 21 out of 23 intrinsic investors viewed this negatively. In subsequent interviews, some investors noted that this could lead to a downward spiral, where reductions in investments like marketing and sales would produce lower revenue growth, which would then lead to more reductions in marketing and sales expenditures to keep short-term earnings from declining.

Another scenario tested investor reactions to a new CEO's decision to continue operating a legacy unit even though it was a money loser and had no expectation of turning profitable. Seventeen out of 24 of the investors from our panel had a negative view of sustaining the unit to avoid recognizing the shutdown costs, while 20 were neutral or positive about the company shutting it down—despite the one-time hit to earnings. Most favored an attempt to divest the unit in the CEO's first year on the job, with the only dissenter worried that action in year one might be a bit too quick.

Take charge of investor communications

With respect to investor communications, intrinsic investors tell us they favor companies with executive teams that are confident about telling their companies' stories the way the teams see them, proactively choosing how, what, and when to communicate. Many of our survey panelists felt that is the opposite of what many companies do today. To paraphrase one investor, "An exceptional CEO knows what I need to know and tries to persuade me of that. He or she doesn't try to guess what I want to hear."

Intrinsic investors expressed this as a desire for what they called education. One investor told us, "I just need to be educated. Help me understand

your business and strategy. If I disagree, I don't have to invest." They want to know what a company's competitive advantages are and how its strategy builds on those advantages. They want to know what external and competitive forces a company faces. And they want to know what concrete actions the company is taking to realize its aspirations—including efforts to ensure it has the talent to succeed. They don't want sugarcoating, opacity, or "selling." They also see right through overly elaborate presentations as a potential lack of substance.

Related to education, investors want to learn how a CEO makes decisions, whether the company's approach is aligned with long-term value creation, and whether the whole management team is singing from the same song sheet. This is not surprising, given that 23 out of 24 of our long-term investors rate management credibility as one of the most important factors they consider in making investments. Management credibility includes not just clarity of decision making but also openness when not everything goes well. One investor put it this way: "There are always bumps in the road. You earn trust and respect by not trying to sugarcoat. That doesn't mean the stock price won't go down. But it will mean the recovery will be better because investors will have more confidence in managers who are level headed and matter of fact." Another investor said, "I get them to talk about something other than what's in their pitch book. I want to know how they think. For example, what's their rationale for a particular decision that will increase value?"

Another theme we heard from intrinsic investors, one supported by behavioral psychology, is that managers would do well to ensure that the long term and its context are part of every investor engagement, especially when talking about short-term results (see sidebar, "What can investors do?"). Start with the long term as the wide lens and then zoom in on the details, as needed. As one investor averred, "It's all about the horizon. Long-term investors don't need a lot of detailed guidance about quarterly numbers. They need clarity, consistency, and transparency from managers in communicating strategic priorities and their long-term expectations."

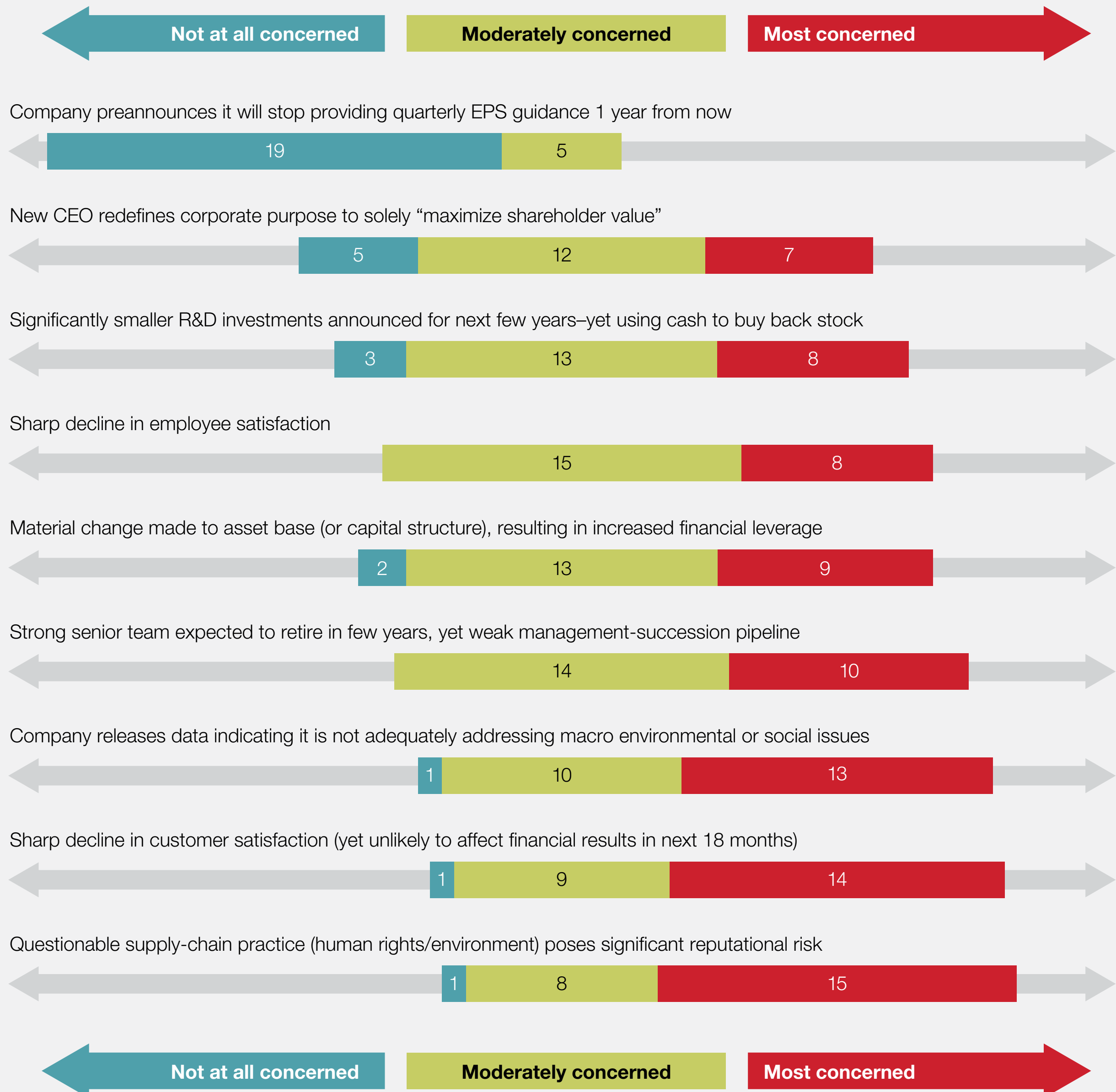
Resist artificial moves to meet earnings targets

Many companies believe they are forced to game their quarterly earnings, even if they don't like this. A number of studies have shown that it is common for companies to defer investments to meet short-term earnings targets. One of the earliest found that 80 percent of CFOs would reduce discretionary spending on value-creating activities, such as marketing and R&D, to meet their short-term earnings targets. And nearly two-fifths of CFOs would give discounts to customers to make purchases this quarter rather than next.[7]

Most long-term institutional investors deplore such moves. From one investor: "We think that running a business with a goal of meeting consensus expectations for revenue or earnings per share creates temptations for suboptimal choices. We prefer to invest in businesses with fewer, simpler long-term goals and no near-term guidance."

That has implications for the pressure companies feel, whether real or perceived, to report steadily increasing earnings each quarter—for the quarterly call itself, for the comparison of earnings with analysts' consensus estimates, and even for the practice of providing earnings guidance. For example, intrinsic investors reject the premise that companies need to do whatever it takes to meet the consensus numbers. Only 3 of 24 investors in our survey thought it was important for companies to consistently meet or beat consensus estimates for revenue or earnings. They realize there are too many factors outside management's control to

Exhibit 2 **Long-term investors are less concerned about quarterly earnings guidance than about news that affects long-term performance.**



[1] For all options except "Sharp decline in employee satisfaction," n = 24; for satisfaction decline, n = 23.

Source: McKinsey and Aspen Institute panel of long-term investors

consistently meet the consensus. Most of them say they are satisfied with a company sometimes beating estimates and sometimes missing, as long as the company is making progress toward its long-term goals. That's consistent with previous McKinsey findings that more than 40 percent of the companies that miss their consensus earnings estimates actually see their share prices rise, despite the conventional wisdom that missing analysts' estimates invariably leads to major stock-price declines.[8] And when stock prices do fall precipitously, it's almost always because of other bad news that was conveyed at the same time as the earnings release.

Intrinsic investors also generally oppose earnings guidance, especially quarterly guidance. Among various indicators that investors might watch, only 5 of our 24 participants said they would see a company's announced intention to discontinue earnings guidance one year from now as a "yellow flag" or reason to keep watch (Exhibit 2). The rest said they would do nothing about their current investment in a company that decided to discontinue guidance in a year's time.

Rethink quarterly calls

One common practice that contributes to the perceived importance of quarterly earnings is the quarterly earnings call itself. Most intrinsic investors don't like quarterly calls and find them a waste of time. For example, when asked about how a CFO should allocate her or his time engaging with investors, only 4 of 22 long-term investors thought quarterly calls were the most important. In contrast, 19 of 24 investors preferred one-on-one meetings and less frequent but more long-term-focused investor days or strategy conferences.

From our discussions, we concluded that it's not the idea of the quarterly call itself that intrinsic investors object to. Rather, it's the quality of the quarterly calls as practiced today. Several intrinsic investors objected that "half our time is wasted listening to a scripted speech we could easily read before the call." Moreover, during the Q&A period, virtually all the questions are from sell-side analysts trying to enhance their quarterly earnings models rather than trying to understand how what happened in the quarter affects the long-term value of the company. The leader of a large investment company participating in our discussions decided to listen in on some earnings calls and was appalled by the poor quality of questions, including some by analysts from his own firm.

To improve the quality of earnings calls, we suggest a few experiments. One investor's recipe for a good conference call had three parts: "Give detailed information in advance, spend as little time as possible regurgitating results already included in the press release, and focus on the Q&A. But police it more aggressively to eliminate repetitive questions, minimize short-term-oriented questions, and reduce sell-side modeling questions, such as 'what is next quarter's tax rate.'" Other investors described companies with helpful quarterly calls as those that remind investors of the company's long-term strategy and goals before diving into the short-term results—and those that connect the short term to the long term during the Q&A session.

A majority of intrinsic investors surveyed favor eliminating the reading of scripted comments and giving more time to Q&A. Taking that even further, 15 out of 25 long-term investors favored asking investors or analysts to submit questions in advance—and only 3 objected. That helps companies give prominence to the questions asked most frequently and prioritize those that are most relevant to interpreting the quarterly results as indicators of long-term performance. To prevent management from avoiding important questions, a portion of the call could be devoted to questions asked "live."

What can investors do?

The burden of shifting the emphasis toward long-term thinking doesn't fall exclusively on companies. There are ways that long-term institutional investors can amplify their expectations and perspectives in the minds of busy corporate boards and management. These include the following:

Ensure that the types of questions you ask are linked to the long term, whether directly or indirectly. Several investors in our pilot group have experimented with how they engage with companies. Instead of questions about the current year, one portfolio manager focused specifically on asking executives for more information about key actions they were taking to execute their strategy. Others ask questions to test a company's strategy, such as how it will hold up against competitors' actions. One senior chief investment officer gave straightforward guidance to his analysts on how they should approach a one-to-one conversation with the management of a current or prospective portfolio company. He told them to ask themselves whether they were viewing the interaction as a valuable opportunity to learn and not just wasting management's time.

Tell companies what really matters to you. In particular, emphasize the importance of long-term revenue growth and return on capital as key drivers of value. As one investor told us, "Earnings per share (EPS) is not important. It is not a metric to use when thinking of building value over time." If you agree, then reinforce that message in your communications with the company—and explain what does matter: the drivers of EPS, not EPS itself.

Encourage companies to change the format of quarterly earnings calls. In general, intrinsic investors tell us they are reluctant to publicly ask questions on these calls. You might encourage companies to shift to anonymous questions submitted in advance, for example. This could encourage more intrinsic investors to speak up and lead to more long-term-oriented questions. It will also show executives that there are influential intrinsic investors who aren't obsessed with quarterly earnings.

Emphasize your focus on the long term. When talking to managers one on one, explain how you interpret short-term performance. For example, for some companies, intrinsic investors pay close attention to organic revenue growth and its drivers, such as how fast the company's markets are growing and what the company's innovation pipeline contains. Make it clear that high EPS growth isn't valuable to intrinsic investors without organic revenue growth. Companies cannot overcome poor organic growth by cost cutting and share repurchases to boost EPS growth. Emphasize that when companies cut costs and improve margins, you want assurances that those cost cuts are true efficiency gains, not reductions in investment in market building, product development, and geographic expansion.

Explain to a company's board, when invited, how you look at the company. This can be an effective means of ensuring that the board of directors also encourages a longer-term view of performance. It may also encourage the board to change incentive compensation systems to more integrative, less formulaic approaches that encourage sustainable, long-term value creation and discourage short-termism.

To have questions submitted in advance, there must be some time between the earnings announcement and the quarterly call. Investors had mixed views about the length of time between announcements and calls: 10 out of 25 respondents were comfortable with at least a 24-hour gap. In discussion, others said they preferred something shorter. For example, earnings could be released after the market closes and the call could occur the next morning. This practice is already used by some companies.

It's time for executives to take a harder look at themselves in light of their complaints about short-term pressure. There are enough long-term investors who see themselves, as one investor put it, "on a journey with management." By finding, working with, and making decisions with those investors in mind, managers will find their task of focusing on the creation of long-term value easier. ■

[1] Dominic Barton, Jonathan Bailey, and Joshua Zoffer, *Rising to the challenge of short-termism*, Focusing Capital on the Long Term, FCLT Global, fcltglobal.org, 2016.
[2] Robert N. Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey Quarterly*, April 2008, McKinsey.com.
[3] Ibid.
[4] The Aspen Institute Business and Society Program, founded in 1998, is a policy program of the Aspen Institute, a nonpartisan forum for values-based leadership and the exchange of ideas. The program works with business executives and scholars to align business decisions and investments with the long-term health of society and the planet.
[5] *Rising to the challenge of short-termism*.
[6] The group overall consisted of investors from 25 organizations. The sample varies because not every investor responded to every question.
[7] John R. Graham, Campbell A. Harvey, and Shiva Rajgopal, "The economic implications of corporate financial reporting," *Journal of Accounting and Economics*, 2005, Volume 40, pp. 3–73.
[8] Tim Koller, Rishi Raj, and Abhishek Saxena, "Avoiding the consensus-earnings trap," January 2013, McKinsey.com.

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How activist investors are transforming the role of public-company boards

Collaboration between activists and traditional asset managers is changing the boardroom. Here's how.

David R. Beatty

Like it or not, hedge-fund activism has become a characteristic of the corporate landscape. In 2015 alone, activists made public demands of some 637 companies worldwide.[1] In 2016, they'd already made demands of 625 companies by the end of October.[2] And these are just the campaigns that are made public: there are probably at least as many that are never covered by the press because of a quiet settlement between the activist and the target company's board.

What constitutes an activist and the definition of embedded funds does vary. But combined, there appear to be around 550 "active activists" around the globe,[3] controlling more than $180 billion in embedded capital—up from $51 billion in 2011.[4] Most are centered in the United States, but new firms have also sprouted up in Australia, Canada, Europe, and Hong Kong. And to magnify their clout, they are increasingly attracting the interest of asset and pension-fund managers and collaborating in transformative campaigns.[5] Working together, they could mobilize trillions of dollars to challenge the strategies and performance of publicly traded companies.

Whether you see hedge-fund activists as a catalyst for beneficial changes in governance and strategy or

short-term opportunists detrimental to long-term value creation, this much is clear: the growing influence of activists on global capital markets will fundamentally transform how public-company boards interact with investors. This includes the role of the board in investor relations, the importance of outside voices, and more transparent relationships between directors and company managers.

Boards must now be directly involved in investor relations

All medium and large public companies have investor-relations departments that report regularly to the board about shareholding levels and shareholder concerns. But traditionally, few, if any, directors would actually visit a shareholder to discern his or her view. Most boards would meet with their largest and most interested shareholders at the annual general meeting. But beyond that, reports from investor relations were more than likely deemed sufficient to understand the views of investors. Even now, some companies still have explicit policies that preclude directors from communicating with investors.

Today, as a direct consequence of shareholder activism, boards and executives frequently review lists of the largest shareholders in order of percentage of holdings. They then decide on a consultation strategy that may well include a visit from an independent director without any management being present. Mary Jo White, the outgoing chair of the US Securities and Exchange Commission, has even publicly stated that shareholder relations are now a board duty: "The board of directors is—or ought to be—a central player in shareholder engagement."[6]

Public examples abound. Among companies, Andy Bryant, the independent chair of the board at Intel, meets with four of the company's largest shareholders each quarter. Sometimes CEO Brian Krzanich or other senior managers are present, and sometimes other independent directors join in. Among asset managers, Larry Fink, CEO of BlackRock (with an estimated $5.1 trillion in assets under management), wrote an April 2015 letter to all S&P 500 CEOs, urging them to have "consistent and sustained engagement" with their shareholders.[7] And Bill McNabb, CEO of Vanguard Group (with an estimated $3.5 trillion in assets under management), has encouraged boards to promote communication with shareholders through, for example, a new "shareholder liason committee" or other structures.[8] The board of Tempur Sealy International has now created a Stockholder Liaison Committee.[9] A new industry of advisory organizations has already sprung up to help boards cope with these new shareholder-relations responsibilities.

Corporate strategy must consider alternate perspectives

In most, if not all, corporations, senior managers lead an annual strategy meeting to examine where the company is headed with respect to its competitive context. Typically, these are two- or three-day occasions, held off-site, with the agendas carefully planned to maximize the likelihood of developing a coherent and insightful strategic plan.

In fact, according to a recent McKinsey survey,[10] boards have significantly increased the time they spend on strategy. This is not surprising given the ever-increasing complexity of the global and digital world we live in. Corporate strategy is tougher to hone and of shorter duration than ever before. An increasing number of companies now insist that strategy be on the agenda of each and every board meeting, so that the directors can be assured that they are investing their time in the most important function: helping to figure out and navigate the way ahead.

When it comes to the traditional off-site, there is a real chance to go back to the basic roots of company competitiveness and to reexamine assumptions and past approaches. This is almost always led by the C-suite team, but it can include external speakers with specific company knowledge. If you, as a director thinking about the next strategic review, were reasonably certain that activists were closely examining your company, why not actively invite their insights?

Given current norms and expectations, asking activists to report their view of alternate corporate strategies to the board may be awkward, or even threatening. But failure to understand alternate strategies to maximize corporate performance might well lead to an open proxy fight. To look at the matter in a less threatening way, instead of having to spend millions on a consulting review, you could get one for free from would-be activist investors.

Board relationships with management must become more transparent

Relationships between a company's directors and its CEO and C-suite executives depend upon many things, especially the trust between the chair (or lead director) and the CEO. These relationships have always evolved over time, as companies progressed or failed to progress and as CEOs grew into their positions. But the basic operating norm in the past would be to let the managers get on with running the business and fundamentally trust in their strategy for doing so.

Today, the presence of activists in the market have further transformed these relationships. Questions about performance and strategy have never been absent from board meetings, but with the level of activist interest, they are now always front and center. Directors—who are fundamentally dependent on management for information and data—must constantly be aware that activists and institutional investors are also closely examining their performance. And boards that don't understand alternative points of view on corporate strategy and bring them to the top management team for consideration can never be fully confident that the management's view of the world is the right one. The outcome can be bitter. Failure to find out who is interested in your company and who might have a different twist on the strategy can quickly lead to damaging hostilities that could be lethal to the company, its employees, and its customers.

One meaningful step toward greater transparency internally would be to appoint CFOs to companies' boards of directors. As directors, they could be charged with discerning where activist investors are proposing different approaches—and with purposefully representing any alternate asset-deployment strategies. Since CFOs don't "own" capital investments the way operating executives and the CEO might, they can afford to be dispassionate third-party evaluators of investment flows and alternate investment strategies. This is a long-standing practice in the United Kingdom, recognizing the CFO's knowledge of a company's assets, the returns on those assets, and often

Questions about performance and strategy have never been absent from board meetings, but with the level of activist interest, they are now always front and center.

a profound viewpoint on the likelihood of a performance improvement.

Activist funds allied with asset and pension-fund managers have transformed the landscape of shareholder involvement. By embracing the three principles outlined above, directors will be better prepared for what's ahead.

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Fundamental Finance

The value premium of organic growth

Beware of letting acquisitions take priority over organic growth.

Marc Goedhart and Tim Koller

It's not surprising that many executives think about growth primarily in measures such as acquisitions. For some, opportunities to grow organically are limited, especially in maturing or contracting product markets. Others are drawn to the allure of high-profile deal making, with its virtually instant boost to revenues and often earnings per share as well.

But executives shouldn't underestimate the power of organic growth. It may take more time and effort to affect a company's size, but organic growth typically generates more value. A look at the share-price performance of 550 US and European companies over 15 years reveals that for all levels of revenue growth, those with more organic growth generated higher shareholder returns than those whose growth relied more heavily on acquisitions[1] (exhibit). The main reason is that companies don't have to invest as much up front for organic growth.[2] In growing through acquisition, companies typically have to pay for the stand-alone value of an acquired business plus a takeover premium. This results in a lower return on invested capital compared with growing organically.

We often see companies pass up organic-growth opportunities because they take longer to boost earnings than acquisitions do. But, given an option, they should probably tip the balance toward what they can achieve organically. ■

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1 We grouped 550 large US and European companies into thirds based on total revenue growth. We then ranked the companies in each tercile by their increase in goodwill and intangibles as a proxy for acquired growth, and again broke them into thirds based on their level of acquired growth. We then compared the median TRS for each of the nine groups. Since our proxy is imprecise, the chart shows the TRS only for those companies with the most and least organic and acquired growth. The sample excludes the banking and insurance sectors, which severely underperformed in this period because of the 2008 financial crisis. It also excludes the extraction and commodity sectors because their performance is strongly affected by commodity-price cycles.

2 There is a selection bias in our sample: not all companies that invest in organic growth actually realize that growth.

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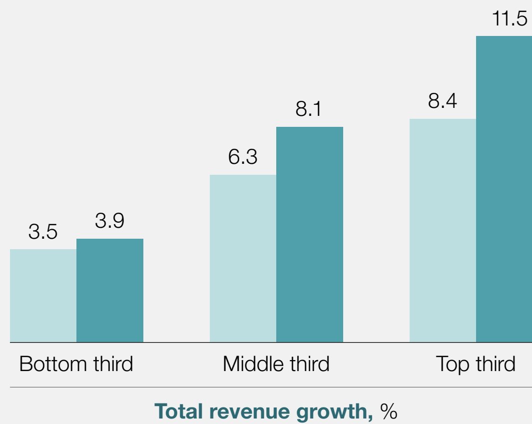
Exhibit

At comparable total growth levels, companies with more organic growth outperform those with more growth from acquisitions.

Annualized excess shareholder returns relative to the S&P 500[1]
1999–2013, %

Least organic | Most organic



[1] Excludes banks, insurance companies, extraction companies, and cyclical commodities.

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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

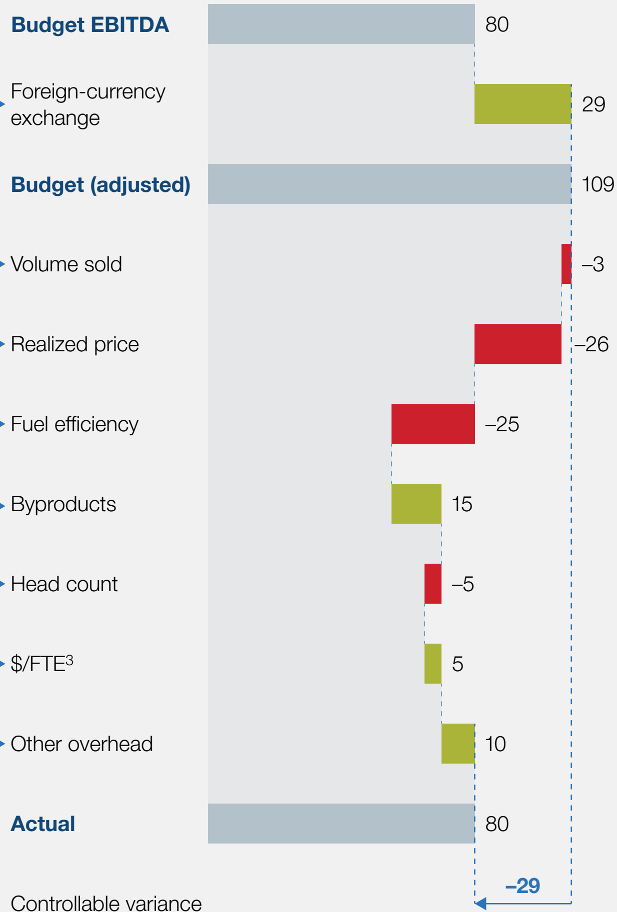
Reporting business performance against the measures that affect value clarifies what really matters with respect to cash flow.

$ 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.

Ankur Agrawal, Brian Dinneen, and Ishaan Seth

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.

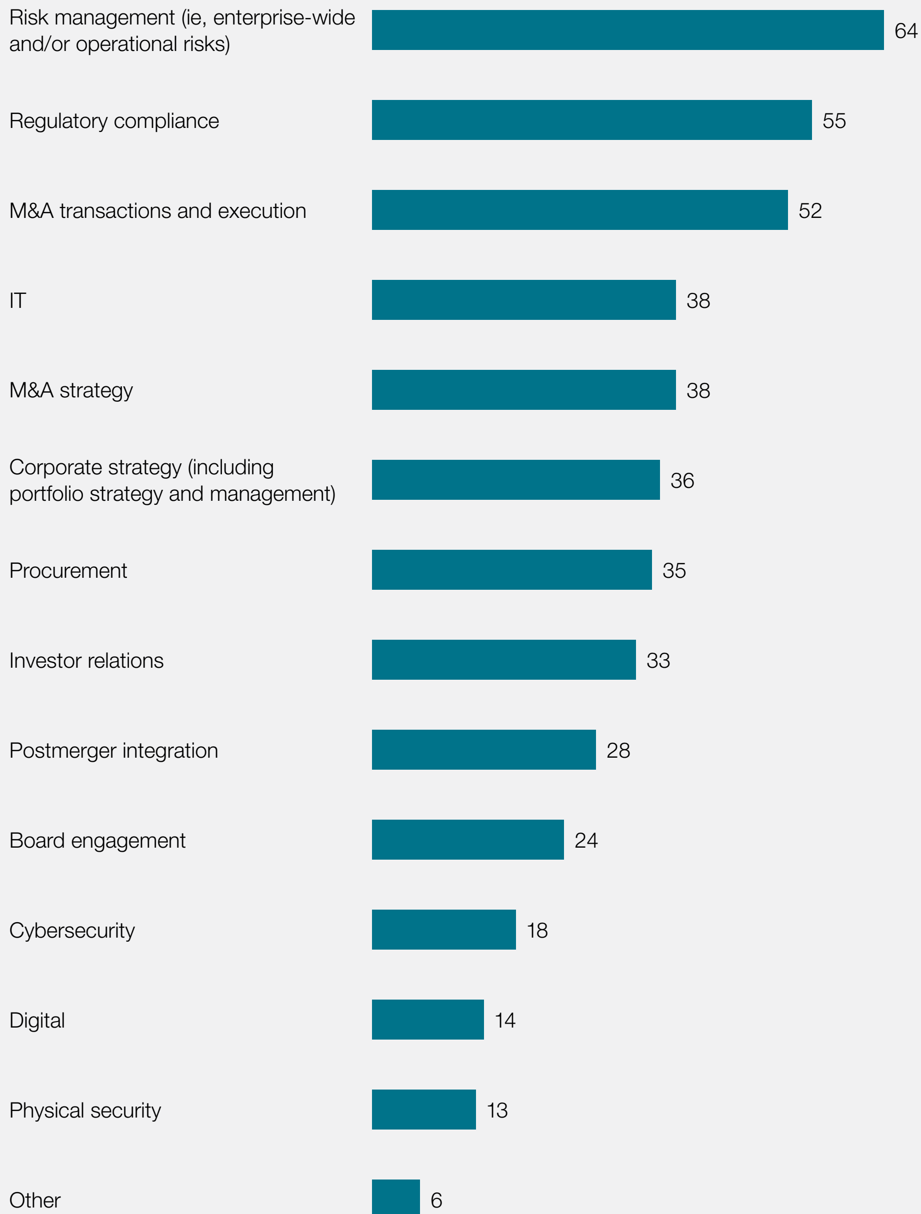
Most CFOs know it's no longer enough to play their traditional role. Instead, for CFOs to deliver value as their duties evolve, the results suggest that they must build skills in other areas of the business, play a more active leadership role, and rethink their usual approaches to overcoming external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

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

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

% of CFOs,[1] n = 193



[1] Respondents who answered "don't know" are not shown.

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.

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).

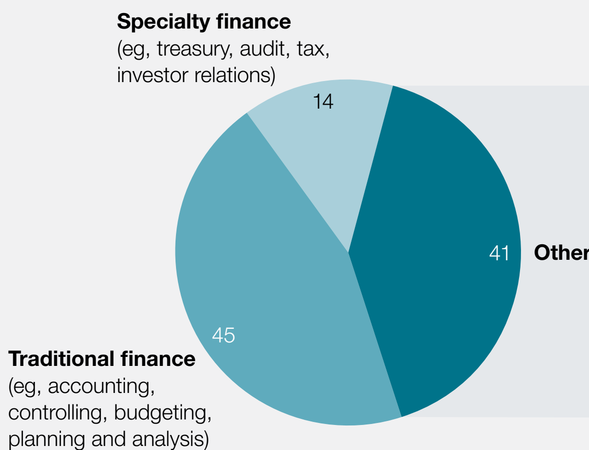
What's more, CFOs themselves and respondents in other roles believe that CFOs can create value in several ways, and not necessarily by fulfilling traditional duties. Eighteen percent of CFOs say that, in the past year, they have created the most value for their companies through their traditional finance work. But others are most likely to cite

Exhibit 2

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

% of CFOs[1]

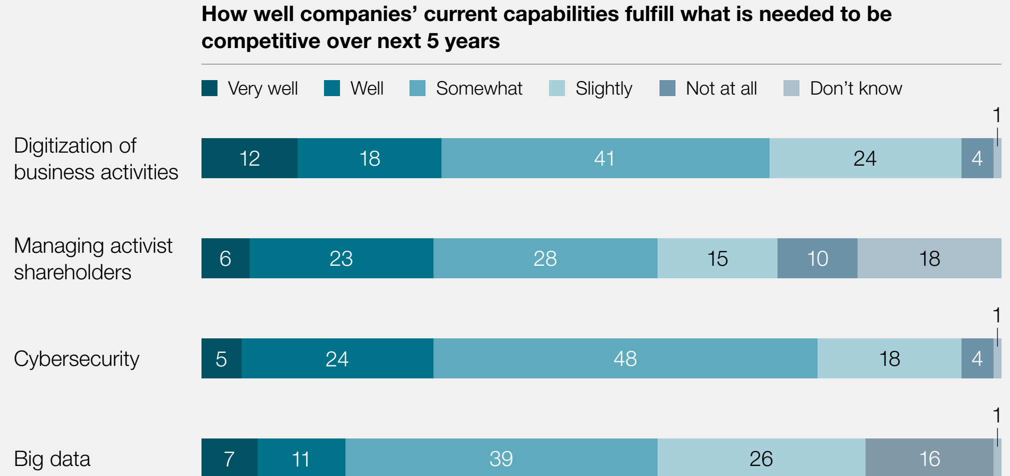
Roles where CFOs spent the most time, past 12 months



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.

Exhibit 3 **For newer activities and trends, such as digitization, few CFOs say their companies are prepared to be competitive.**



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 the digitization of business activities. Less than half feel their companies are well prepared or very well prepared to be competitive on cybersecurity capabilities (Exhibit 3).

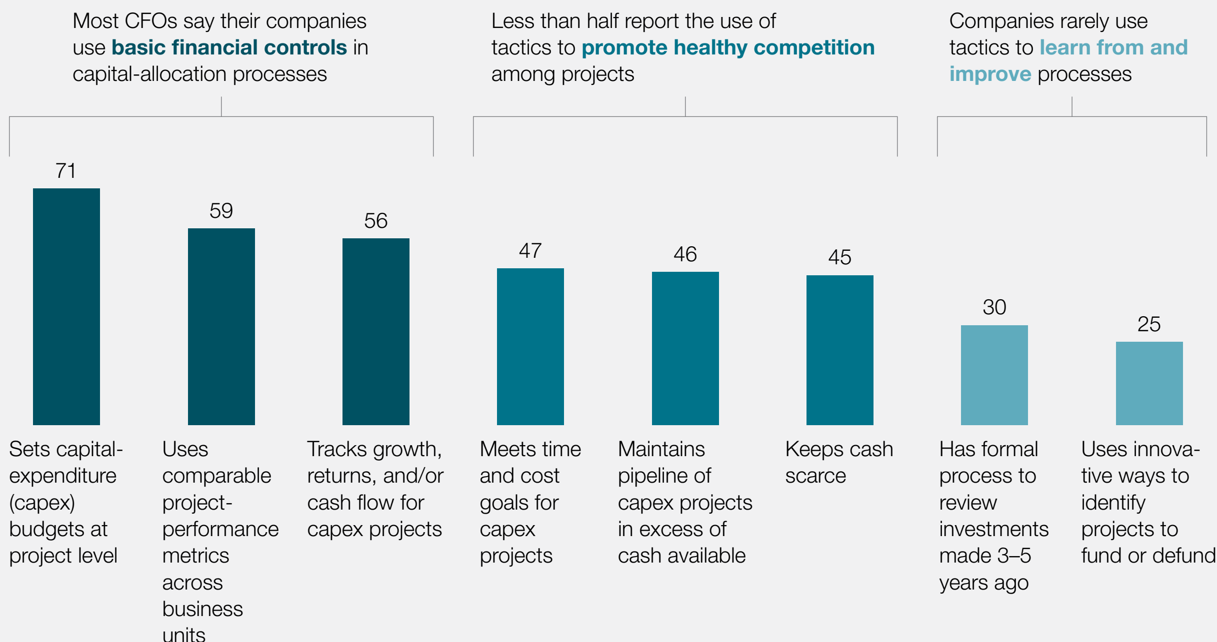
The need for more strategic CFO leadership

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 allocat-

Exhibit 4

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



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

ing 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 do. 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.

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.

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.

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 the other challenges that they are being tasked with managing. ■

[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.

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