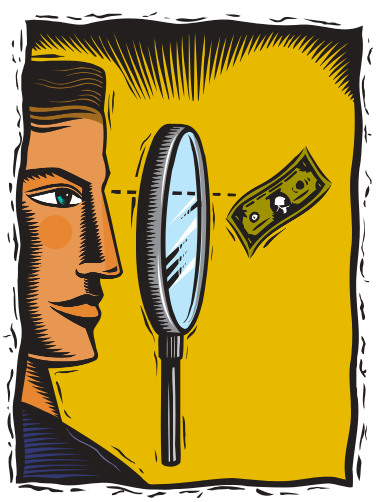
Strategy, Value Creation, and the CFO

By Mark L. Frigo

What is my organization's strategy? How does this strategy create real financial value? What role do I play in the value-creation process? These are questions every CFO should be asking since, having solid financial discipline, they're in the best position to link strategy to execution and financial success. In order to leverage that financial discipline, the CFO needs a strong understanding of how a particular strategy and its value drivers contribute to true value creation.

Recent surveys have found that CFOs are indeed focusing on more forward-looking activities such as strategy development and decision support, which is leading to a greater strategic contribution from the finance function. To make this strategic contribution, finance needs to have four key clusters of knowledge:



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Return Driven Strategy

Corporate success—measured by any for-profit organization's ability to ethically generate sustained, long-term returns on investment for its investors—depends on strategy being focused on financial value creation and returns. Return Driven Strategy, as described in earlier columns, is an approach that serves as a diagnostic of existing strategies and those under consideration, and it's a powerful tool for developing strategy designed for executability, profitability, and ultimate investor returns.

A 2002 study by CFO Research Services and Cap Gemini Ernst & Young ("CFOs: Driving Finance Transformation for the 21st Century") found that 60% of the CFOs surveyed cite their role in the development/formulation of corporate strategy as a priority. Yet only 25% say the rest of the organization views finance as a value-added function to be consulted on all important decisions. In addition, the survey found most CFOs are dissatisfied with the contribution that the finance function makes to shareholder value: Only 39% are very satisfied that the finance function consistently influences the decisions that drive shareholder value.

Another survey—this one by Heidrick & Struggles—asked CEOs to describe the qualities they look for in their CFOs. Strategic planning rated as one of the top two. A survey of 1,400 CFOs by RHI Management Resources in 2000 asked how they see the role of the CFO changing the most over the next five years. This survey found that more strategic planning and increased leadership in decision making were top areas of change.

To actually contribute in the area of strategy and value creation, CFOs must have the right skills in their departments. Some companies have a program in place to develop their finance employees' skills, including building leadership abilities and training people to think strategically, but more need to do this.

Genuine Assets

What role do intangible and tangible assets play in the value-creation process? According to a Brookings Institution study, the value of a corporation is based mostly on intangible assets, with information capital being the most significant component. Genuine assets need to be considered when you're creating and executing strategies intended to drive excess levels of profitability and abnormally high growth.

What are genuine assets? They refer to all the tangible and intangible traits and resources that make an organization and its strategies unique. Because they are the "building blocks" of strategy, the ways they are combined form the basis for creating sustainable competitive advantages. And only through these advantages can you plan and execute corporate initiatives that lead to higher returns, higher growth, and, ultimately, increased market value. Without this process, you may overlook key ingredients to successful strategy and end up struggling to compete without differentiating your company.

Strategic Performance Measurement Systems

Strategic performance measurement systems like the balanced scorecard and value-based management (VBM) are powerful tools for executing strategy. The balanced scorecard is an approach to performance measurement that includes nonfinancial and financial performance measures derived from an organization's vision and strategy. Balanced scorecard strategy maps can help management describe and test the cause-and-effect linkages inherent in key strategic themes—such as growth and productivity—within the balanced scorecard framework. These linkages describe how improvements in performance drivers, such as faster process-cycle time or employee capabilities, can create improvements in outcome.

Value-based management is the term given a process used to determine the drivers of a particular strategy, understand how those drivers link to value creation, and then break those drivers down into steps for action and activities that can be pushed throughout an organization all the way to the shop floor. Value-based management shouldn't be confused with the actual *design* of strategy—it represents a vehicle and process for strategy execution translated into the specific value drivers for that particular organization.

What roles do CFOs play in strategic performance measurement? According to the CFO Research/Cap Gemini survey, CFOs play a critical role: 69% of senior financial executives say they are deeply involved in communicating and advocating strategy internally, 67% are highly involved in translating strategy into operational actions, and 64% are highly involved in providing analysis to link strategy to shareholder value. The survey found finance functions playing a key *continued on page 59*

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role in developing companywide performance metrics.

Strategic Valuation and Performance Measurement

Another key role of the CFO is to provide his/her company with an understanding of the valuation and performance-measurement methods that will best facilitate strategic and operational decision making.

The guidelines of strategic valuation and performance measurement provide a refreshing alternative to the endless performance metric debates that have so plagued corporate management over the last decade. The days of deciding "which metric is best for me" should be over. No metric is ever "best" in every situation, even when dealing with a single company in a single measurement period. The right perspective recognizes the ability of the CFO and corporate management to learn and decide when certain calculations should or shouldn't be made. Instead of implementing a fixed set of adjustments, the CFO should implement a set of financial intelligence around how performance should be measured. For example, instead of saying "always add goodwill to the investment base in an ROI calculation," the CFO should implement guidelines that recognize when goodwill should be capitalized and when it shouldn't…generally in executive compensation, not always in resource allocation. Each adjustment depends on the strategic decision at hand.

Strategic valuation and performance measurement begin with a sound philosophy pertaining to and a sound judgment surrounding how strategic decisions will be made and how performance measurement will be used to make decisions. In order to make the necessary adjustments to create measures that reflect economic reality and not merely adherence to some preset dogma, management must be flexible. This means that, realistically, different calculations of return may be necessary, depending on the use of the metric, be it in executive compensation, resource allocation, mergers and acquisitions, or a host of other important activities. Economic profit may be the best calculation in one corporate initiative, while cash flow returns are best in another.

Doesn't this make sense? After all, the economy is fluid, not rigid. It isn't static. It isn't inflexible. And neither should our performance measurement or valuation methods be.

What role will you play in your company's strategy development and execution process? How well are performance measures aligned to your company's strategy and to the tenets of value creation? As a CFO, your personal value proposition is dependent on how well you can answer these questions and act upon the answers. ■

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