ROLES FOR THE 21ST CENTURY

OVER THE PAST FEW YEARS, CFOS HAVE SEEN THEIR ROLES ALTER DRAMATICALLY AS BUSINESSESS MAKE THE TRANSITION FROM THE OLD ECONOMY TO THE NEW, SAYS **JAMES SAGNER** OF SAGNER/MARKS.

The responsibilities of the chief financial officer are rapidly changing from those of just a few years ago. A major driver is the evolution of the business organisation from the old, industrial economy to the new economy model, with intellectual capital becoming more important than the traditional classical factors of production: land, labour and financial capital.

As a result, the CFO's roles have become considerably more than managing the cost of capital, determining that accounting entries are correct, and ascertaining that appropriate insurance coverages are secured. Their role requires an intimate knowledge of the core elements of the business, regardless of their traditional assignment, while working in concert with other senior managers to optimise operational processes. These actions are necessary to fulfill the CFO's basic responsibility to the organisation: the maximisation of shareholder value.

There are numerous roles that the CFO will be performing in the third millennium. We review six of these activities in the sections that follow.

☐ BANK RELATIONSHIPS

How are bank relationships managed? In the industrial economy, credit decisions were based on pricing and banking institution relationships, while treasury staff processed transactions using traditional bank products. In the intellectual capital economy, lending will be rationed, forcing CFOs to search for credit, while non-critical functions will be outsourced or managed in shared service centres.

THE PREVIOUS SITUATION IN THE US. Prior to the passage of the 1994 Riegle-Neal Act (ending the 1927 McFadden Act restrictions on interstate banking) and the 1999 Gramm-Leach-Bliley (deregulating financial services), banks were confined to specific markets and product lines. As many as 15,000 banks (down to 8,620 banks at the end of 1999) competed for corporate credit and non-credit business. Banks scrambled for corporate business, and the resulting low cost of debt capital contributed to substantial external financing (that is, from sources other than retained earnings), from about 10% in 1993 to over 15% by 1999 (according to Federal Reserve System statistics).

In cash management services, the US banking industry has clearly been moving toward an oligopolistic structure from one of substantial competition, leading inevitably to price increases beyond the rate of inflation[1]. A recent survey noted that the consolidation in banking has nearly doubled in five years, with the largest banks controlling 47% of cash management revenue, versus 27% in 1994[2]. This group of five banks will average more than two and a half times the level of domestic activity as the next group of five banks.

THE FUTURE ENVIRONMENT. For the first time, banks are able to allocate capital based on the comparison of returns from lending activities to returns of other financial service companies. With sophisticated costing systems, banks have finally realised that commercial lending and cash management are marginally profitable activities, and that their scarce financial resources may be more profitably allocated to financial services merger and acquisition (M&A) activities, consumer lending and other uses.

As a result, corporates are increasingly facing a chilly reception from their banks. An AFP survey in February 2000 indicated that bank lending – recently, half of all corporate borrowings – is expected to be down to about 37% in 2001[3]. CFOs are becoming the salesmen of the financial world, traveling with their roadshows to sell their stories to rating agencies, lenders, investment bankers and journalists. Because of the banks' reluctance to accept credit business, the number of potential credit contacts has had to be significantly increased, sweetened by promises to reassign non-credit business from long-time relationship banks.

In one case, a New York Stock Exchange-listed client that enjoyed a 100-year relationship with a money centre bank was told that a line of credit would no longer be available, despite a investment grade rating and a superior balance sheet. In this situation, the credit supports commercial paper issuance, which funds the liquidity requirements of the company. Lower-tier banks in the relationship provided some relief, but the desired aggregated credit line was not attained.

For companies forced to search for capital beyond the commercial banks, alternative sources include various non-bank lenders. Inevitably, the allocation of capital will be based on creditworthiness, size and profitability, as old and new economy companies compete for the finite amounts of capital that are available. CFOs must impose strict capital rationing for new capital projects; must ally with partners to accomplish the company's strategic mission; and must be prepared to motivate credit sources with equity sweeteners. However, some credit business will not be placed and capital will not be secured.

☐ FINANCE'S FOCUS WITHIN THE ORGANISATION

What are the responsibilities of finance within the organisation? In the industrial economy, it was providing capital and accounting reports. In the intellectual capital economy, the role is being significantly expanded into nearly every significant business function.

THE PREVIOUS SITUATION. Finance has traditionally been a staff function separated from other line and staff activities, focused on accounting, treasury and insurance matters. In many companies, this isolation was only overcome at the senior manager level, usually in cabinet-type meetings involving the various chiefs of departments and the chief executive/operating officer. This phenomenon is often referred to as the 'silo' effect, which is essentially us against them, without regard to the collective needs of the organisation[4].

> 'THE INTER-RELATIONSHIP OF BUSINESS FUNCTIONS WILL REQUIRE RELIABLE, ALMOST REAL-TIME INFORMATION ON HOW EACH ELEMENT IS PERFORMING, RATHER THAN LIFELESS BUDGET REPORTS'

Direct reports to the CFO typically have not been concerned with the operations of the business, and often do not have any idea what debits or credits are referring to in the real-world of inventories, labor and sales. Comptrollers, treasurers and other financial managers do not accompany the sales force on customer calls, or spend any significant time on the production line, or investigate information systems issues. Instead, they tend to remain in the friendly confines of their offices, without understanding the real meaning of the numbers on their computer screens.

THE FUTURE ENVIRONMENT. The silo mentality is ending at many companies, largely because of the growing realisation of the inter-relationship among all functions in a business. There are several reasons for this attitudinal change, including:

- **Competition.** Customer and supplier relationships have generally been friendly, based on long-established counterparty relationships. The future business environment will demand a more aggressive response to global competition, with the penalty for apathy the loss of market position, perhaps one that has been secure for decades. The CFO is responsible for assuring that his or her company is productive and efficient, which requires regular interaction with other elements of the business.
- **Cost of capital.** The significant increase in the cost of debt and equity capital in the past three decades – now about two and a half times the average weighted cost in 1970 – forces CFOs to really understand and participate in decisions regarding the investment of capital in projects with suspect future returns. This development requires financial manager immersion in many of the activities of the business and the accompanying destruction of silo barriers.
- **E-commerce.** Despite the collapse of many internet stocks in 2000-2001, many observers believe that the business to business (B2B) market will reach trillions of dollars by the end of this decade. Ecommerce allows user-friendly interaction between buyers and sellers of products and services, access to global markets and minimal transaction costs. Further impetuses are dissatisfaction with the rigid protocols of electronic data interchange (EDI) as well as the expense and time required to implement EDI formats and the continuing desire to convert paper to electronics.

☐ BUDGETING AND ACCOUNTING

How are budgeting and accounting activities handled? In the industrial economy, managers relied on fixed budgets that became obsolete. In the intellectual capital economy, dynamic planning is a requirement and the only certainty is change.

THE PREVIOUS SITUATION. Accounting debits and credits result in journal entries, which enable the accountant to prepare trial balances and financial statements. All of this reports the past, both in terms of actual costs and revenues and in their relationships to volumes and profits. Costs are often reported using conventions which distort the actual costs incurred, as with LIFO inventory accounting (which assumes that the last item bought is the first to be sold).

In the global economy, companies have been accustomed to the reporting of financial results by country, with local currencies, language and customs driving accounting decisions. While statements are consolidated for the purpose of global reporting, little management information has been available to determine product, customer or market profitability.

Budgeting is obviously necessary to control expenditures over the coming fiscal period. However, the process is often static, in that once established, budgets are difficult to change to reflect new opportunities and challenges. Revenues assume a continuation of past pricing trends, which may significantly change with inflation or deflation, or in the face of predatory competitors. Costs, likewise, assume past relationships, despite such events as overtime, severe materials shortages related to demand, weather or other influences, or rising energy costs.

THE FUTURE ENVIRONMENT. As the CFO extends his or her domain beyond the finance silo, they will be able to see practical applications of budget and accounting reports that actually assist senior managers in decision-making. The inter-relationship of business functions will require reliable, almost real-time information

on how each element is performing, rather than lifeless budget reports of little relevance to anyone except the affected managers.

International change drivers include competition from the European Union (EU) and the acceptance of the euro as the currency of Europe (except for Great Britain), allowing the development of meaningful global financial statements based on product profitability. This will require consistent definitions of accounting data, standardised systems and a single currency for all transactions.

Planning will be continuous, based on accounting data compiled and available on a nearly real-time basis. As a result, accounting closings will be virtual, with reports issued within hours, rather than 10 or 15 days after the end of the fiscal period. Budgets will be revised based on a continuous stream of data on sales, expenses, profits, competitive actions, and results versus plan. Profitable activities will be discovered and rewarded, marginal ventures will be reviewed for inefficiencies, and decisions made as to corrective action.

☐ MANAGING THE COST OF FINANCE

How are the expenses of the finance function managed? In the industrial economy, the focus was on traditional cost-cutting mechanisms to reduce costs. In the intellectual capital economy, consideration will be given to internal improvements, shared services and outsourcing.

THE PREVIOUS SITUATION. Finance once involved extensive professional and clerical staff to manage such activities as making accounting entries, calculating cash balances, ordering stock, reviewing loan documentation, and reconciling bank accounts. Pressures to reduce costs involved headcount reductions as supplemented by increased use of technology to perform such routine tasks as journal entries, repetitive money transfers and check signing.

Financial managers examined their charges from banks and suppliers, and were able to negotiate lower fees for information reporting; depository, concentration and disbursement services; credit arrangements; accounting fees and insurance premiums. Due to regulatory constraints, banks faced a competitive environment and could not price services for adequate returns.

THE FUTURE ENVIRONMENT. With the emerging oligopoly in non-credit banking services and the retreat from commercial bank lending, CFOs have begun to encounter fully priced services and credit rationing. Cost savings have not come from the negotiation of lower fees; instead, companies face significantly higher charges for bank and supplier services. As a result, internal improvements, shared services and outsourcing must be considered in managing the finance function.

The process of determining the opportunities for internal improvements and outsourcing to finance were reviewed in an earlier study[5]. The determination of costs is a complex exercise, as many component costs are spread throughout various responsibilities in any organisation. We cited the example of collection processing, which involves at least five organisational units: the mailroom, accounting, treasury, information systems and customer service.

However, once the relevant cost categories are identified, the financial manager can begin to consider the impact of various internal improvements. For example, collections could include the consolidation of processing sites, lock-boxing, headcount reductions, using part-time employees, improving availability granted by deposit banks, and using mini-computers, rather than the mainframe computer.

☐ MERGERS AND ACQUISITIONS

How are M&A opportunities evaluated? In the industrial economy, corporate finance procedures calculated operational and financial synergies. In the intellectual capital economy, decisions will be based on global portfolio theory incorporating the measurement of risk.

THE PREVIOUS SITUATION. For the past half a century, corporate finance has utilised discounted cashflow (DCF) techniques to evaluate investment alternatives, both for internal expansion and M&A activity. Deals are often assumed to be accretive by the end of the first year, with positive incremental benefits through a combination of revenue enhancements and cost reductions. However, probably three out of four M&A deals are disappointments, due to a combination of excess premiums paid; bad advice from investment bankers; low morale and leadership problems, particularly in the acquired company; and timing and execution.

Many deals appear to be motivated by the desire to please investor and analyst demands for growth, which inevitably is faster through acquisition than through internal expansion. As a result, many mergers have been between similar types of businesses,

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resulting in a sort of buying of customers, rather than the thoughtful construction of a portfolio of assets to manage shareholder risk.

THE FUTURE ENVIRONMENT. While increases in revenues and the customer base, along with reductions in costs, will continue to be an essential element in M&A decisions, CFOs will emphasise the construction of a portfolio of investments that diversify the risk and returns for the company. Merger problems often arise because of the positive correlation of the returns from each component of the new organisation, causing increased return on equities (ROE) in boom times but losses in recessions.

Furthermore, over-emphasis on concentration within an industry is likely to raise the prospect of an anti-trust review, regardless of the orientation of the political party in power. Large mergers may injure customers, reduce innovation, cost thousands of jobs and stifle competition, and do not always lead to greater efficiency and profits.

The new M&A megadeals such as Citigroup, DaimlerChrysler and AOL Time Warner have been allowed to proceed so long as

competition is maintained. Where it is not, as in the Microsoft case, litigation may result.

Conscious decisions to diversify risk by merging complementary businesses can assist in reducing joint risk, while improving the possibility of a successful long-term strategy. M&A activity can assist in the restructuring of large old and new economy companies by such asset realignment, to improve shareholder returns and discard underperforming assets.

☐ INFORMATION TECHNOLOGY

What role does the CFO have in information technology (IT)? In the industrial economy, decisions on IT were made by the senior information officer and supported by the CFO. In the intellectual capital economy, the CFO is an equal partner with IT.

THE PREVIOUS SITUATION. Information technology decisions have been driven by IT, particularly concerning systems affecting the entire organisation, even though many information applications have substantial finance implications. The 1990s saw widespread acceptance of enterprise resource planning (ERP) systems, which include general ledger and related systems such as invoicing, receivables, payables and treasury information. In many situations, the CFO was instructed to support the decision on ERP or other computer software or hardware, or on telecommunications facilities, regardless of cost, implementation effort or appropriateness.

THE FUTURE ENVIRONMENT. With the ERP market reaching $50bn each year[6], the CFO needs to exert his or her influence on decisions for further investments. Finance must determine the value of these investments to the business, must assure the accomplishment of these goals, and must determine how better decisions will result.

Too many technology decisions are made on faith, rather than on a thoughtful analysis of the returns from the commitment of capital, time and organisational co-operation. The resource of value in the 21st century new economy organisation will be information, more than any physical asset, and it is essential to formalise the responsibility for protecting this asset and using it wisely and economically.

MANY RIVERS TO CROSS. The CFO faces an incredibly complex and dynamic business environment, one in which they will be as important to the success of the business as the chairman or CEO. The six areas discussed in this review are extremely important but represent only a portion of the numerous issues facing tomorrow's financial managers. Other concerns include costing systems (including activity-based costing), taxes, risk management, the valuation and protection of intellectual capital, dividend policy and stock repurchase programmes, implementation of quality programmes and rating agency relationships. This busy agenda will drive the CFO's roles in the next century.

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NOTES

[1]Pricing data shows price increases of 3.0% from 1999 to 2000. This exceeds the rate of inflation, with the consumer price index rising at a 2.7% rate over that period. See Executive Summary, 2000-2001 Phoenix-Hecht *Blue Book of Bank Prices*, at www.phoenixhecht.com.

[2]Reported as 1998 Ernst & Young *Cash Management Services Survey*, TMA Journal, Sept./Oct. 1998, pp. 40-46.

[3]*AFP Survey Shows Shift in Credit Resources*, AFP Pulse, Feb. 2000, pages 1, 7.

[4]For a more complete discussion of this phenomenon, see James Sagner, *Financial and Process Metrics for the New Economy*, AMACOM, 2001, Chapter 1.

[5]See James Sagner, *Cashflow Reengineering*, AMACOM, 1997, Chapter 3.

[6]Estimate by AMR Research, cited in Fay Hansen, *Drivers of Finance*, Supplement to Business Finance, Feb. 1999, pages 2-5, at 5.

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