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The new operating-finance partnership: a potent strategy for value creation

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Good things often happen to organizations in which the operating and finance people work together as equal partners, or what we call "partnering for performance" (PFP). In the absence of such collaboration, other organizations pay a heavy price. This is true for all organizations – whether public or private, profit or nonprofit – and is supported by an abundance of real world experience.

To assist readers in quickly assessing the potential contribution of PFP for their respective organizations, this article will summarize this model and discuss some key points and recent developments that underscore its growing importance.

Partnering for performance creates value

The basic reason for PFP is value creation. All organizations must be prepared to demonstrate their ability to create value, that is, to add value (through developing new products or services, gaining new customers, enhancing efficiency, etc.) faster than it is being destroyed (by technological developments, changing customer preferences, inroads of competitors, rising costs, etc.). Otherwise, they will be unable to attract the funding needed to attain their objectives and will cease to exist.

In the business sector, value creation means not only selling products or services that customers want, but also doing so in a way that will provide a return to current or prospective stockholders that is competitive with returns available on alternative investments of comparable risk. This return can take the form of dividends, a rising stock price based on expected results in future periods, or both. The criteria for measuring value creation for nonprofit and governmental organizations are generally non-financial, but again resource constraints apply, and there is considerable competition for funding.

Although the valuation of stocks is a forward-looking exercise, investors are still interested in current performance that has a bearing on future results. If earnings have grown 5 percent per year over the past five years, for instance, it would be reasonable to assume – unless there is evidence to suggest otherwise – that they will grow at that rate in the future. Even though a company is not currently profitable, or never has been, investors may still be inclined to see better times ahead if revenues are growing 25 percent per year and concrete steps are being taken to get costs under control.

The message that stock valuations are likely to suffer if actual earnings or cash flow results disappoint is not necessarily a popular one, especially when it follows that cherished initiatives may need to be scaled back or

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eliminated. Accordingly, there have been recurring suggestions that other perspectives should be given equal or greater weight.

Since the 1970s when the Boston Consulting Group market-share/growth-rate matrix was in vogue, an eclectic array of non-financial thrusts has been advocated as a means of attaining the Holy Grail of sustainable competitive advantage. The list includes differentiating the product offering (versus concentrating on being the low-cost producer), driving core competencies, reengineering business processes, and coopetition (a combination of cooperation and competition) – seemingly anything but better financial thinking (Mand and Whipple, 2000; Boyett and Boyett, 1998).

We have attributed the preference for non-financial strategies to the influence of management strategy gurus, but such a view may confuse cause and effect. Perhaps it is the gurus who have been influenced, i.e. motivated to develop theories that would appeal to operating people who chafe under the tyranny of the "bottom line" (which is perceived to be the sole focus of finance).

Finance people are not necessarily unsympathetic to such feelings. Currently, for instance, a book by PricewaterhouseCoopers' Eccles *et al.* (2001) maintains that conventional financial reports fall far short of meeting the needs of investors and the public. To escape from "the earnings game," the authors advocate "ValueReporting." By this they mean extending the "balanced scorecard" concept to external reporting, thereby reflecting the value of people, products, ideas, reputation, and research in financial reports.

Given the deficiencies of earnings data (as distinguished from cash flow) and the disconnect between the book value and economic value of a firm's business and assets, we would not dispute that improvements to the financial reporting framework are desirable. Note, however, that procedures to place systematically a value on "soft" assets in the financial reporting context could have unintended consequences, such as saddling reporting companies with onerous legal responsibility for unrealized expectations. Also, any realistic valuation of such assets must be based on the cash flows they can be expected to generate, not the cash that was expended to create them, which brings one full circle to a financial perspective.

The ValueReporting concept has reportedly been welcomed by CEOs of technology companies who "believe that current financial reporting models do not serve their needs and result in much lower share prices for their companies." Three-quarters of technology executives said that their company's stock was undervalued in recent surveys, despite their active efforts to disclose information to the market (*Business Wire*, 2000).

Investors evidently saw things differently, for the stock prices of the technology companies that dominate the Nasdaq index have undergone a wrenching adjustment over the past year or so. Among the icons whose stock prices have plummeted are Amazon.com, Cisco Systems, Intel, Oracle, and Yahoo. Many smaller technology companies have been hit even more severely and seem fated to go under now that the availability of venture capital is drying up for all but the most solid prospects.

It would be difficult to view the carnage without concluding that the Internet has not "changed everything" after all. New companies as well as old (many of which have also experienced stock market reverses) will continue to be put to the value creation test. The real surprise is not that technology stock prices have fallen so far, but that they rose so high in the first place, based on expectations that were often weakly substantiated.

If investors were misled by anything, in our view, it was by wishful thinking and a seductive sales pitch rather than inadequate financial data. Certainly some astute observers warned that the valuations of the technology companies were extraordinarily high and are now in a position to say "I told you so," or words to that effect. According to Buffet (2001), a well-known skeptic when it comes to investments in new technology because he does not see any way to pick the winners intelligently, a "bubble market" gave rise to the promotion of companies "designed more with an eye to making money *off* investors rather than *for* them."

The current market correction will have the salutary effect of refocusing the energies of technology companies on the necessity of building a profitable, cash-generating business, rather than rushing to do IPOs to fund a level of expansion that ultimately will prove non-sustainable. Many technology companies are now scrambling to prune expenditures that cannot be expected to generate an attractive return, dispose of underutilized assets, and find new sources of revenue (even if this means that the public will have to pay for

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some of those "free" services on the Internet) (*The Economist*, 2001). For those that succeed, a bright future beckons, and we believe that finance people can play a major role in bringing about the kind of creative adjustments that need to be made.

A boom and bust cycle, such as many of the technology companies have just experienced, is far from ideal. With a partnering relationship between the operating and finance people, the value creation imperative can be built into the decision-making processes of an organization from the outset rather than being belatedly recognized as a result of pressure from investors, donors (nonprofits), or taxpayers (government agencies). Financial considerations can thereby be addressed in a timely fashion while minimizing the disruption of operating objectives.

PFP is for everyone

There is an understandable tendency to view partnering for performance as a finance initiative that is tinged with some degree of self-interest, although such is far from our intent. To begin with, our model calls for changes in the thinking and behavior of finance people so they can successfully play the role of "shareholder value enabler" (SVE). The new beliefs we advocate are:

- they are business people, first and foremost;
- they are equal equal contributors;
- they are customer-focused;
- they offer unique perspectives (internal, external, corporate);
- they have a proper sense of urgency;
- they are innovative;
- they have high ethical standards;
- they work hard, but also have fun.

Furthermore, finance people have a strong stake in the success of PFP, because it means they will be invited to actively participate in making strategic business decisions as opposed to merely being called in when it is time to implement them (the customary finance role in many organizations). From the perspective of operating people, it might seem logical to place the responsibility for implementing PFP on the finance people. After all, they are the ones who will benefit from having more clout in the organization. Let them make the required adjustments while operations focuses on strategic issues.

In reality, operating people must be involved in the PFP equation, and they must be prepared to make changes in their beliefs and behavior. They must accept the fact that financial objectives will be more constructively attainable when addressed as part of the strategic planning and business decision-making process than when addressed as a regrettable afterthought, and they must become familiar with financial techniques that can enhance their own effectiveness (see Table I).

Operating people must also be willing to give up deeply ingrained stereotypes about finance people. Stereotypes such as "bean counters," "number crunchers," and "controllers" are often based more on past events than on present realities. In addition, finance should cease to be viewed as staff (i.e. subordinates) or simply a cost center. Operations must buy into the SVE beliefs instead of adopting an attitude of "we'll know they have changed when we see it."

The foregoing requirements are not meant to suggest that finance people should not strive to continuously improve their efficiency and effectiveness, but to underscore the point that an undue emphasis on functional excellence will obscure the true potential of PFP. It is no more possible to work as equal partners with people who are always shutting you out than to clap one hand. Ergo, the active support and involvement of the operating *and* finance people in an organization is

Table I — Financial techniques that operating people know

Cash focus	Understand that cash flow is a simpler and more meaningful measure than earnings
Discounted cash flow measures	Use these measures for performance measurement as well as incremental investment analyses
Activity-based costing	Avoid pointless debates about expense allocations
Decision- and risk-analysis	Ensure that everyone has a stake in risk assessment
Options theory	Since uncertainty is inevitable, make the best of it

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essential if PFP is to be more than just another "buzzword."

PFP achieves gains and avoids pitfalls

There are many financial strategies that can help to address organizational challenges – from focusing on the businesses that a company is best equipped to pursue (e.g. by selling or spinning off businesses that do not fit in a company's portfolio) to shaking up an overly complacent corporate culture (e.g. by implementing a leveraged recapitalization or implementing a stock option plan with rising exercise prices). Similarly, most operating strategies have a financial dimension. Whatever strategies are chosen, the involvement of both operations and finance is needed to plan and execute them well.

One of the most powerful tools to grow a business – or get it in trouble – is strategic acquisition. Even if the numbers look great to finance, an acquisition may founder if the operations and management cultures of the two companies are not compatible. There have been significant problems in making the Daimler Benz-Chrysler merger work, for instance, and most of Chrysler's top managers have departed.

On the other hand, an acquisition that is a good fit from operating and cultural standpoints can still fail if the target company is overpriced. For example, it is commonly believed that Hercules was forced to put itself up for sale as a result of taking on too much debt to acquire Betz Dearborn.

Many companies have implemented a stock purchase program as a means to return cash to the shareholders that cannot be reinvested in the business at an attractive rate of return. Such a strategy reduces the need for growth, which may not be feasible under the circumstances, and is more tax efficient than paying dividends. The timing can be critical, however, because purchasing stock that is overpriced will reward stockholders who sell as opposed to those who stick with the company. Several companies, including Bank of America, Bank One, Anheuser Busch, Eastman Kodak, Aetna, and Alcoa, have suffered the embarrassment of seeing their stock price go into a prolonged decline after a stock purchase program (*The Economist*, 2000).

There can be a lot of second-guessing when a problem surfaces with a company's products, such as the failures that led to the recall of millions of Firestone tires. One of the predictable issues is whether the problem resulted from a financially-driven decision to cut corners on product design. On the other hand, no company can afford to set its product or service specifications without regard to whether the cost involved can be recovered in selling prices, because customers will pay just so much for the proverbial "better mousetrap." The trick is to strike the right balance.

While PFP is hardly a panacea for all organizational ills (nothing is!), it does encourage joint decision-making and action by the operating and finance people in situations like the ones we have described as well as many others. It will also spark ideas for becoming more productive. For example, no one in the organization is satisfied with the budgeting process, as the results never seem to justify the time and effort expended by so many people, but neither finance nor the operating people can effectively improve the process by themselves. Working together, we have no doubt that they can simplify and speed up the budgeting process, thereby obtaining more meaningful results with less effort. Similarly, organizational and sector scorecards can jointly be improved by putting PFP into practice. Given the stakes involved in seeking to meet the value creation challenge, namely success and even survival, it is hard to see why an organization would be willing to settle for anything less.

The obstacles to the effective implementation of PFP

Some people have commented that the central tenet of PFP is already well-known and accepted, from which it might follow that organizations should look elsewhere for the key to future progress. As the *Financial Executive* (2000) put it:

> The concept behind *Partnering for Performance* isn't revolutionary. In fact, it's become a common refrain in recent years: the chief financial officer and the finance function need to be an integral part of management in order for a company to operate at maximum efficiency.

Other observers recognize the possibility of a gap between theory and practice. One reviewer of our book agreed that finance has "an image problem" (*Sloan Management Review*, 2000). Another playfully called finance "the Rodney Dangerfield of the business world," because "it just can't get no respect" (Mahler Company, 2000).

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Although the latter comments are encouraging, let's face it: saying that the operating and finance people in an organization should work together does sound somewhat obvious, just as it would sound uninformed (if not "politically incorrect") to suggest that finance or any other group should hold itself apart from the rest of the organization. Why stop there, in fact, when one could go on to say that everyone should work together?

There are some special reasons to focus on the operating/finance interface, notably the fact that the operating and finance people in an organization play entirely different roles. A football team with a great offense cannot win the Super Bowl if its defensive unit and special teams are not good as well. Similarly, organizations need operating people to satisfy customers/grow the business and finance people to help ensure that the organization attracts the funding it needs and applies its financial resources to create value.

In making the case that operating and finance people often fail to work together, we have found it convenient to refer to numerous real-world examples. Some of these events happened a few years ago and may be characterized as passé. However, as the old adage says, "the more things (form, procedures) change, the more they (substance, end results) remain the same." Yes, we live in an era of very rapid change, but by far what is changing the fastest is technology, not human behavior. For all the talk about how companies and people are "reinventing themselves," such changes are often more a matter of style than substance – or of perception versus reality.

Many finance people believe they have already made the transition to a business-partnering role, but operating people see considerably less improvement. Table II shows the results of a recent survey (Walther and Johansson, 1997[1].

Another potential objection to partnering for performance is that organizational cultures vary widely. While some organizations may have never heard of PFP and others may not know how to implement it, some organizations believe that the model is second nature for them. Given the human tendency to claim more progress than has actually been made, we estimate that 90 percent of all organizations would probably classify themselves in the latter group.

To guard against premature declarations that "victory has been achieved," leaders of these companies should bear in mind that PFP is more an art than a science. The implementation of the PFP model is not a one-time event, but rather a process that must be repeated and perfected over time. Even in companies that achieve a high order of PFP, there will continue to be areas where further progress could be achieved and new people who need to be brought up to speed.

Do not allow your organization to fall prey to complacency. Unless it is very clear that the operating and finance people are working together effectively at every level, now may be just the time to implement PFP in your organization.

Table II — Two views of finance

Question	Finance manager responses (%)	General manager (%)
Is finance a business partner?	Yes – 28	Yes – 12
Is finance involved with the business?	Yes – 66	Yes – 25
What is finance's primary role?	Business advocate – 73	Policeman – 71

Note

1. We have substituted the word "finance" for "CFO" to depersonalize the results.

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