CHAPTER 1

Today's Challenges, Tomorrow's Aspirations

What a difference a few years makes! After tremendous upheaval and uncertainty, the corporate world has restored its reputation and is eager once again to take advantage of the opportunities presented by changing global dynamics. World markets are opening up as never before. India and China are having a massive impact. And major players in every industry sector are moving aggressively to reap the benefits of brand and scale.

It's now more than three years since a series of major financial scandals rocked the capital markets. Companies in the US such as Enron, WorldCom, Tyco, and even Arthur Andersen, started the ball rolling. In Europe, problems at Ahold, Parmalat, and Shell continued the trend. The world's regulators responded; some would say they overreacted. But on mature reflection, the prevailing view coming through from leaders of the world's top corporations is surprisingly positive!

What's the feedback from CFOs on the front line? Smaller companies may view the regulatory burden as intolerable. Others may believe that many well-run and responsible companies are being penalized for the mistakes of the few. And in many respects, the regulation and standards are too detailed, too complicated, and often confusing. Nevertheless, some larger companies believe that the new regulations have actually done them some good; secretly they may even feel that they strengthen their dominant positions and reinforce their barriers to entry.

Undeniably, the fresh emphasis on corporate governance has been beneficial – and proven to be a much needed shot in the corporate arm. Despite all the controversy surrounding the new regulations and accounting standards, there is now a far greater awareness of both an individual's responsibilities and a corporation's liabilities. And this is all to the good: it's brought new rigor and more transparency to businesses worldwide.

How are leading companies responding? And how are the roles of the CFO and the finance function changing as a result? Even with their preoccupation with regulation, transparency, and accountability, we are seeing a greater appreciation among CFOs of their vital role in value creation.

In the corporation as a whole, in fact, the roles of the CFO and Controller have undergone a step-change in importance. Chairmen, senior non-executive directors (NEDs), and CEOs of leading companies are more involved than ever before in the CFO's world: corporate governance, control, and risk are all very high on their agendas. So, too, are the escalating demands of investors and regulators who are setting higher standards, changing accounting rules, and requiring more and more information. Underpinning all this change is the need for "business as usual" – to meet the needs of the customer, to beat the competition, to grow shareholder value, and to innovate.

Every CFO we've interviewed aspires to similar goals. What differentiates them is their starting point. In this first chapter, we provide an overview of key issues addressed throughout this book. First, we look at how GE's finance function is supporting its innovation edge. Then we explore how senior finance executives at companies such as Ahold and Parmalat have assisted in the recovery from accounting scandals. We offer the views of a leading chairman on the impact of changes in governance and regulation. We go on to show how the CFOs of companies such as Philips and Diageo are making change happen from a position of maturity and leadership in their sectors. The chapter concludes with an introduction to the remainder of the book – the value creation agenda for the future.

We start with an in-depth interview on how GE tackles the twin-challenges, the "*two-headed monster*": regulation and innovation.

RIDING THE TWO-HEADED MONSTER

GE is among a select group of companies widely recognized as best-practice leaders in finance. It's also one of the most admired corporations in the world. How does the finance function help GE sustain its financial performance, maintain its world-class reputation, cope with never-ending regulation, and keep tight control over what is arguably the largest, most diverse global industrial enterprise? We begin with an interview with Bjorn Bergabo, a CFO in the GE Commercial Finance division.

BALANCING GROWTH WITH CONTROL

Bjorn Bergabo, CFO GE Commercial Finance, Corporate Financial Services Europe, General Electric Company (and extracts from the GE 2004 Annual Report)

GE is one of the largest, most respected and sustainable companies in the world. Revenues in 2004 exceeded $150 billion, earnings grew to $17 billion, and the company remained one of only six "Triple A" rated US industrials. Our shares trade at a premium, as an industrial multinational because GE inspires investor confidence – in terms of growth, high return on equity, and low overall risk.

Marketing and Innovation

GE recently launched a process for innovation called "Imagination Breakthroughs" (IBs), designed to apply GE rigor to the creation of products and services. Each IB project has the potential for at least $100 million in incremental growth. Today, the company has 80 IBs; some may happen soon, others make take ten years to reach full maturity, and still others may not fly at all.

While delivering a total shareholder return of 21%, GE was still able to invest $13 billion in further strengthening its intellectual foundation. We've also announced a new company-wide initiative called "ecomagination." GE has committed itself to reducing greenhouse gases and to making the environmental consequences of its work more transparent. As a company, we're focusing on inventing green technology and on doubling green research spending to develop new products and services.

Over the last few years, GE has undergone a transformation – reinventing itself in order to stay aligned with customers and markets as they've evolved. We have eleven key businesses, including Healthcare, NBC Universal, Infrastructure, Consumer and Industrial, Consumer Finance, and Commercial Finance. In each business, GE provides sufficient information to ensure transparency externally and convey internally its relationship to growth, returns, and investment.

GE's value proposition for business partners and customers is based on the following principles:

- *Best practice sharing: access to proven game-changing tools for leadership development, acquisition integration, and organizational change acceleration.*
- *Six Sigma and Lean Six Sigma: the opportunity to learn and own the Six Sigma methodology used for statistical process analysis, methodology training, and project support.*
- *Business solutions: partners and customers can leverage GE's industry breadth and balance sheet in a variety of sectors, ranging from healthcare and aviation to transportation and automotive.*
- *GE as a channel: GE can be sold to (as a customer) and through (as a channel).*

Role of the CFO

When Jeff Immelt, Chairman and CEO, recently discussed the "role of today's CFO," he emphasized:

- *Ensuring the foundation of integrity: this requires rigorous oversight and sustainable controllership.*
- *Building the systems of accountability: a constant drive to identify and manage both risks and opportunities requiring strong capabilities in financial planning and analysis.*
- *Helping to create a new future: developing business leaders and promoting winning business models.*

Keith Sherin, GE's Group CFO, set out the challenge recently for the finance function: "To remain good business partners, given the increasing focus on controllership." It's the dichotomy between these two roles that companies like GE must reconcile.

Finance as business partners

Finance at GE's Corporate Financial Services division has a dual role – business partnership and controllership. As business partners, they have to bring finance knowledge to complement the expertise of other players. As team players in finance, they meet commitments of the business.

We're involved in leading business initiatives to grow the business and champion quality. As controllers, we need to ensure compliance.

At GE Commercial Finance, we pride ourselves on being one of the world's leading corporate lending businesses – and one of the largest growth engines of GE. Our five major business units focus on customers in areas ranging from fleet to real estate to equipment financing and corporate financial services.

In Corporate Financial Services Europe, we have to stay close to our CEOs to support them. At the same time, we have to provide even better controllership, even more rigor, and even better systems. My role is to support our infrastructure, while also looking forward to see where the business is headed. It's also my job to understand our options and to ensure that we have the right value propositions for the future.

Connectivity with reality of operations

We believe that finance occupies a unique position in the organization: no other function has the same deep involvement across all business issues. All operational activities are ultimately expressed in financial terms. We leverage our organizational positioning to improve results by:

- *Knowing how the individual moving parts translate into results.*
- *Knowing how each moving part affects the others.*
- *Changing operational behaviors to improve performance.*

Generally speaking, CFOs at GE act as operating managers. As a result, we're in a strong position to connect strategy and operations. Finance is a language for expressing performance. Consequently, finance has a lot of power.

Consistency in delivery and execution is a constant mantra. Looking backwards and evaluating performance is vital in keeping the business under control. This is essentially tactical. However, there is a strong emphasis in finance at GE on strategy – focusing not just on the next quarter, but on the next two to three years. Understanding strategic choices from a financial perspective is essential.

How do I spend my time as a CFO in GE's Corporate Financial Services team?

- *1/3 on the past (compliance and controllership);*
- *1/3 on the future (business partnership and global mindset);*
- *1/3 on our people (personal performance and career development).*

The approach to finance at GE is summarized in Figure 1.1.

What binds all this together is a distinctive set of shared values, such as having an external focus, being a clear thinker and inclusive leader – we can achieve better results when everyone is pulling in the same direction. We can combine domain expertise – for example industry specialization – with cross-functional capability. This is where the finance function plays a vital role. Corporate Financial Services provides a wide spectrum of business activities and uniformity is key – there is a strong cultural unity among the people and strong processes, which go right across the company.

Operating rhythm

The GE operating rhythm is the glue across the group and it supports a set of standardized GE business processes. The reviews that occur throughout the year drive GE's success. These reviews range from our three-year strategic outlook to our annual operating plan, from our quarterly short-range outlook to monthly CEO reports and weekly CFO evaluations of operations and cash.

In GE's Corporate Financial Services business, finance executives are constantly "managing" the future. The finance function does not just produce forecasts – it is also held accountable for them. I own the numbers. Although I cannot guarantee certainties, when I produce a forecast, I have to live with it! I need to plan for contingencies: what could happen and what my actions would be. I don't wait until the end

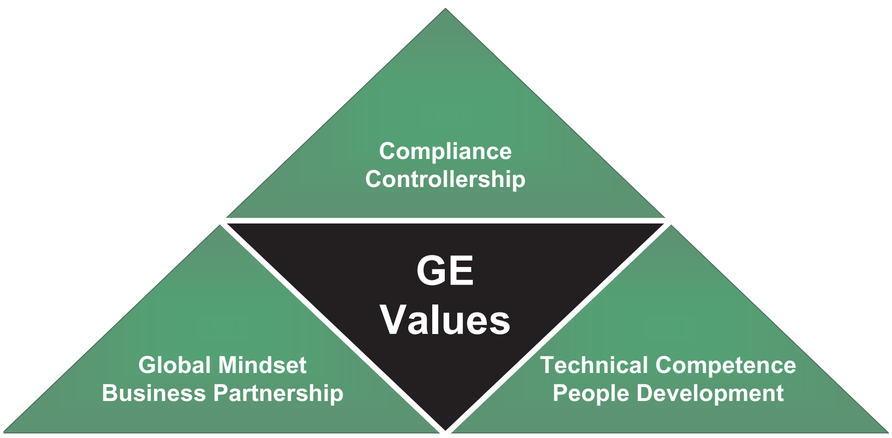

Figure 1.1 *Finance in GE*

of the quarter to report on deviation from plan – I have weekly updates. I work with management in the short term to decide what we need to do to follow our strategic intent.

Corporate audit and controls

There have always been strong reporting lines and accountability for results within the finance function at GE. We're involved in technical and operational controls, as well as financial. Corporate audit, with a staff of 400, is a prominent management presence across GE. Most of our senior finance executives have been through the corporate audit function. We spend more time auditing our financials than ever before to make sure that our controls are even better than they were before. We divide controls into three categories:

- Technical controls – *a focus on integrity; ensuring we comply with policies, maximize returns on invested capital, and safeguard assets.*
- Operations controls – *ensuring quality processes; integrating, standardizing, and taking advantage of our Lean Six Sigma approach to process streamlining.*
- Disclosure controls – *creating credible communications; basing our external and internal reporting on reliable metrics, forecasts, reporting, and analysis.*

We take a very process-driven approach to external compliance requirements: converting and merging them with GE standards; implementing rigorously; and disclosing to external stakeholders consistent, accurate information. As illustrated in Figure 1.2, we have what we call a "controllership value chain."

All accounting requirements – US GAAP, local country GAAPs, and our management results – are managed through one set of systems. As a result, they are fully integrated and consistent – and there is no need for additional adjustments.

The future

Looking forwards, Jeff Immelt, Chairman and CEO, speaks in his 2004 Annual report about a generation of growth leaders: "We've studied great growth businesses at GE and across the world – and our leaders are being trained and evaluated against five capabilities. They must:

- *Create an external focus that defines success in market terms.*

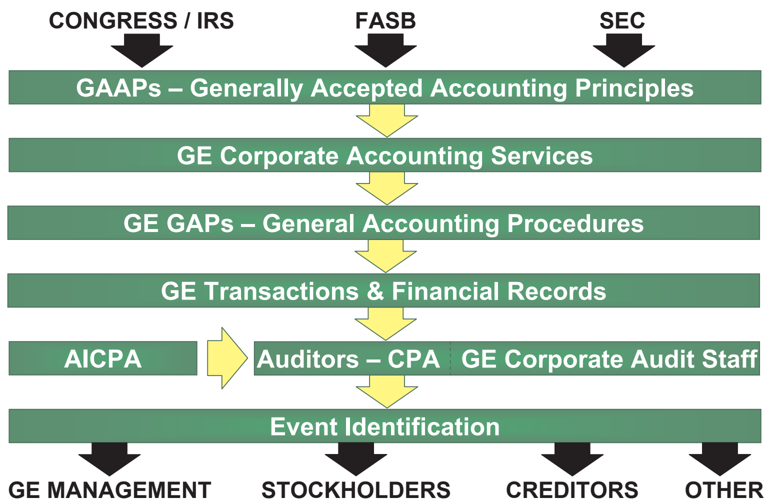

Figure 1.2 *GE controllership value chain*

- *Be clear thinkers who can simplify strategy into specific actions.*
- *Have the imagination and courage to take risks on people and ideas.*
- *Energize teams through inclusiveness and connection with people, building both loyalty and commitment.*
- *Develop expertise in a function or domain using depth as a source of confidence to drive change."*

Jeff goes on to comment in GE's annual report on Sarbanes-Oxley: "None of us likes more regulation, but I actually think SOX 404 is helpful. It takes the process control discipline we use in our factories and applies it to our financial statements. At GE, we embed governance and integrity in the operating culture. High standards facilitate growth. They are not a burden."

Undoubtedly GE's emphasis on the twin challenges of innovation and control is part of its secret of long-term success. Like GE, most companies are focused on sustainable growth. What's different about GE is that it has built a high-tech services and financial enterprise that endures. And its finance function is heavily involved in the business, is sustainable in its own right, and has a distinctive set of shared values that binds finance executives across the company together.

Not all companies have the benefit of GE's corporate reputation and successful track record. Next, we interview two senior finance executives who have a very different starting point from GE – *recovery from scandal*.

GETTING "BACK IN THE SADDLE"

Royal Ahold was one of the major success stories of the 1990s but, unfortunately, it suffered a major meltdown in 2003! Until this point, Europe had not suffered accounting scandals on the scale of America's massive ones, such as Enron and WorldCom. Coming after fraud was discovered at ABB, a widely admired Swedish company, and after the debt crisis at Vivendi, a giant French conglomerate, the Ahold scandal has called into question the belief among some Europeans that their style of corporate governance and ownership is adequate.

Ahold is a Dutch-based international group of local food retail and food service operators. The company operates principally through subsidiaries and joint ventures in the US, Europe, and Central and South America. In 2004, Ahold owned, or had interest in, about 9,000 supermarkets in some 25 countries, as well as a food service business. Ahold owns (in the United States) the Stop & Shop, Giant, Bruno's, and Bi-Lo supermarket chains, as well as Dutch supermarket leader Albert Heijn. As the world's largest food distributor, it has worldwide consolidated net sales of €52 billion and over 200,000 employees/associates. It had grown by acquisition and was very keen on preserving the individual quality of its retail "thoroughbred" brands.

In early 2003, as Ahold was gathering its 2002 results, the world's third biggest retailer announced unexpectedly that it had overstated profits by at least half a billion dollars at its US food distribution service. It also announced that its CEO and CFO were quitting! Ahold postponed its 2002 results indefinitely. Subsequently, an independent evaluation revealed that its profit overstatement was nearer US$880 million.

Until this time, the company had been on a worldwide acquisition spree, acquiring operations from Chile to Thailand and running up net debts of around €13 billion. Its shares had fallen sharply, apparently due to worries about the reliability of its accounts and disappointment at missed forecasts. In response, the group embarked on a program of divestments, jettisoning some of its Latin American and several Asian operations.

Investigation into Ahold's US operations showed that promotional rebates from suppliers were booked fraudulently to meet aggregate revenue targets. Even worse, it was later revealed that promotional payments from suppliers were booked before they were received – stretching the rules, and the credibility of Ahold's accounting methods, beyond the breaking point. It was against this backdrop that Hannu Ryopponen was invited to join the board as CFO to spearhead recovery, refinance the business, and install a new CFO.

REGAINING CONTROL

Hannu Ryopponen, former CFO, Royal Ahold

When I arrived at Ahold, things could not have been any worse! Organizationally, we were set up on a decentralized basis. We had 22 operating companies around the world. The management style was heavily operating-company oriented and we had only a thin layer of regional geographic management at the top.

The bubble bursts!

As our situation was unfolding, the bubble burst around the world! Enron, of course, had happened much earlier, but now we had the high-profile failure of Andersen to contend with. The whole attitude in society towards corporate management and governance changed. For better or worse, controls over business tightened. Sarbanes-Oxley hardened attitudes and expectations: standards of corporate behavior became much higher. In many countries, new codes of conduct – for example, the Higgs report in the UK – were part of this growing trend towards improving corporate integrity.

Suddenly, we moved from the environment of the 1990s to more formal, rigid controls. This was a shock to our system! Not only did senior corporate managers have to respond, others must respond as well – for example, the accounting and legal professions.

When frauds of the nature of Ahold's are disclosed, there are two implications:

1 *People lose their jobs. Some of these people should have known better and there were questions about their integrity. Of course, the finance department was affected dramatically. So we really had no one minding the shop.*
2 *People are paralyzed. It's a bit like a corporate tsunami. People are in shock. They ask the question: "How can I survive this?" Some almost feel guilty; they think they could have done something to prevent the disaster. Others feel personally vulnerable: "Was I too close to the situation? Am I also at risk?" So people become defensive and the organization becomes immobilized.*

Recovering from crisis

When I first started at Ahold, it was only a few months after the disclosure of the accounting problem. I remember my first meeting: it was like talking to ghosts. We had to find new top management: The company was a bit like a body without a head. The supervisory board put a new management in place to provide leadership, energize the company, and resuscitate the share price.

The first challenge, for me, was to close the 2002 annual accounts, which were still unresolved. At least we all felt a measure of relief that things were starting to get back on track. At the same time, we were heavily preparing to raise capital through a share issue, which was successfully completed. We found the necessary financing – €3 billion – in the bank. This was an important step in stabilizing the business.

During 2003, our first priority was reporting – to close the previous year's books, which we only finalized towards the end of that year. Meanwhile, we had not closed a single quarter in 2003! We had a lot of catching up to do. Eventually we closed both 2002 and quarter three 2003. Gradually, we moved towards a normal reporting sequence. Our closing cycle is still slower and more cumbersome than I would like, but we are improving and gaining confidence. We can now show the world that we can close our books accurately and track our progress.

In the short term, we had to bring in consultants to fill the empty jobs. Meanwhile, the forensic activity also required an external accounting firm's involvement. But business as normal had to carry on. We had to restructure for recovery and for the longer term.

If you have forensic investigations, accountants are bound to find problems. In a company like ours, these will always run into the hundreds, all of which need to be acted upon. The accountants found 780 different issues! None of these in them-

selves were ultra important, but they still needed correction. In 2004, we also had to renew our focus on internal controls to comply with SOX 404. Beyond all this, we had to handle the IFRS conversion, which had lain dormant during the crisis year.

Regaining control

First and foremost, we wanted to regain control without the help of outsiders. Second, we wanted to put in the right processes and controls to ensure that they complied with regulations. Unlike other organizations that weren't responding to a crisis, we did not get much resistance to SOX 404 from management and staff.

If I look back at the two years I spent at Ahold, I feel a sense of accomplishment. Given where we were, I do not think we could have done things much differently. We had the whole world watching us. Regulators, investors, the media – everyone was checking up on what was going on at Ahold. They were asking: "How bad was it?" So not only was the organization in shock internally, but we had external pressures to deal with as well. You have to raise quality immediately because the auditors are all over you. There is a lot of checking and double-checking. All your weaknesses are exposed for everyone to see.

Rebalancing the decentralized model

Under the previous regime, we had invested in a series of "thoroughbred" retail brands – these thoroughbreds were raced as if they were individual horses! We needed to herd the brands together while maintaining their individualism. Unfortunately, we had 22 concepts based on the 22 operating companies. We had to decide which ones to keep and which to abandon.

We changed strategy: the decentralized mode of operating wasn't working. The food retail business is low margin and high volume. We needed to go for economies of scale. If you look at the other big supermarket retailers – Wal-Mart, Carrefour, Tesco – they all try to streamline their operations by largely focusing on one operating concept.

We had different accounting and different reporting systems. We needed a "one-stream" reporting approach. We needed one worldwide standard chart of accounts and common definitions – for example, how to define shrinkage, or "like-for-like" sales. We had as many ways of doing things as we had operating companies!

We carried out an analysis to decide how to create economies of scale. For the food service business (which supplies wholesale to hotels, hospitals, and schools) we *had to build a new platform and a new operating model to secure a sound base and to prevent fraud from occurring again. We were still making good profits at the time and had every reason to be confident about the future.*

At headquarters, however, we didn't have the knowledge of the business we should have had. We needed to improve our business analytics – our understanding of what was going on at the front line. It was not enough for the central accounting function just to be bookkeepers, we had to better understand the business drivers underlying performance.

If we had three minutes with the CEO in the elevator, we had to be able to tell him where the business stood financially. But we needed to go beyond what I call the "elevator analysis." For example, if we knew that Stop & Shop sales had gone up by, say, 5% then that was the end of the analysis! We needed to know why they went up 5% and what the underlying drivers were.

The "one-company" approach

We reorganized the operating businesses into a more streamlined management structure – we call it the "one-company approach." Our retail operating companies are now structured into four geographic management regions – we call "arenas" – plus an arena for our Scandinavian joint venture.

We also appointed arena CFOs, each with a very clear reporting line to their arena CEO. They support the business, but they had a strong dotted-line reporting relationship through to me, the group CFO. Depending on the size of the arena, we have arena accounting departments, which have very solid-line reporting relationships to our central Accounting and Reporting function. We installed a new chief accounting officer to take responsibility for a revitalized Accounting and Reporting function – getting the numbers together accurately and on time. We also installed fresh internal audit reviews and controls on the closing processes.

Standardization and harmonization are the goals we strive for today! We are probably more than halfway there. We are standardizing our IT and centralizing our accounting. We are building shared services slowly but surely. We are implementing one center right now in Central Europe. We also have shared services for accounts payable in the Netherlands and in the US. However, we continue to wrestle with the issue of which activities should be located centrally, and which should be local.

We are reducing the variety of accounting systems across the business. Currently we just have four different systems with some variations. We have an agreement in principle across the business to migrate to one standard accounting system and one ERP architecture. IT outsourcing is also on the agenda.

Getting closer to the business

Today, we have a stronger business analytics capability and a better understanding of what is going on. Apart from financial controls, we now have a much better grip on the business. The local CFO's responsibility ends in practical terms at the EBITA level. We have a centralized treasury and tax function. We are getting the treasury staff more involved with the business internally. We are creating better cash management and a deeper understanding of where and how our foreign exchange exposures arise. We are getting everybody closer to the business!

What do I look for in my senior finance executives? High professional standards, and strong personal qualities in terms of leadership and experience. I look for a willingness to cooperate, to work across disciplines and as a member of a team. Strong personal balance is important; so is the willingness to share information happily. Most important, I want people who will be proactive when "something does not feel right." I encourage this proactivity at junior levels too.

In a year or so, I would like to see Ahold back where it deserves to be – a top player in the retailing world. I want the company to be seen by external investors, bankers, and professionals as being a quality share fit for any quality investment portfolio. And, like Philips, I want us to have built a world-class finance function that properly supports the business – and to operate as one company across the world.

Ahold had to reorganize, change its strategy, install a new central accounting and control function, and implement generally higher professional standards. One of the key issues it has grappled with is how much to centralize and standardize – a dilemma for most companies in today's much harsher regulatory and control regime, no matter what their starting point. No one wants to *throw the baby out with the bath water*! A degree of decentralization and local empowerment is still important for an innovative and responsive organization.

In the interests of control and objectivity, should divisional CFOs now have a direct, *firm black-line* reporting relationship to their group CFO?

Some multinationals are following this approach. However, many other companies continue to support the dotted-line relationship between their divisional CFOs and the group CFO, with a firm reporting line to their local CEO. This latter approach does have the advantage of creating a positive climate of business partnership.

Also, there is a growing appetite among investors for much broader, non-financial information to provide a clearer picture of how a company is doing – both in relation to its peer group competitors and in terms of future value creation. Quite often, the latest accounting standards are difficult to interpret and, in some cases, just confusing.

COPING WITH GOVERNANCE AND REPORTING

Is it the role of the CFO to be responsible for this published non-financial information? If so, what are the implications for quality assurance and enhanced control? Remember: the previous Chairman and CFO of Shell lost their jobs for overstating the value of oil reserves. These values were governed by SEC reporting standards but were not included in the balance sheet numbers, just in the supplementary notes, since they were deemed leading indicators of future value.

It's these types of external pressures for higher standards from investors and regulators, coupled with much better defined codes of conduct for corporate governance, that are influencing the role of the CFO and the future of the finance function.

It's now taken for granted in Europe that the roles of chairman and chief executive should be separate. Board committees are commonplace as vehicles for overseeing audit arrangements and senior management remuneration. In mainland Europe there is a two-tier board structure – one for non-executive supervision and one for executive management. In the UK and the US, the single-board approach prevails.

This brings us next to the perspective of senior non-executive directors (NEDs). When we interviewed Dudley Eustace for this book, he was chairman and senior non-executive of many prestigious European companies. However, earlier in his career, he had been Group CFO of Philips, and was appointed interim CFO of Ahold following the scandal. From a non-executive perspective, Dudley comments on the impact of recent changes in corporate governance and regulation – and what it means for a CFO.

A CHAIRMAN'S VIEW

Dudley Eustace, Chairman of Aegon, former Chairman of Smith & Nephew, Vice Chairman of KPN and Hagemeyer

What do I look for in the CFO of a major multinational? Integrity, judgment, and trust. Also, strong reputation and a past track record of success. Independence on the one hand and the ability to be a team player on the other – a real balancing act!

The CFO is the conscience of the corporation. For example, in my experience, growth has a cost: Growth for growth's sake is likely to destroy value. In such circumstances, it's difficult to say no to management. The CFO has to be independent, which can be very challenging. You can't just go on gut feel; you have to deal with realities based on facts.

It is also important for the CFO to have ambition, to want to grow as an individual. I always try to find people who are better than their predecessors – that way, the company can really grow too.

Bringing outsiders onto the board provides a fresh perspective and helps get things done.

Given recent accounting scandals, the Chairman has to be more concerned about what the CEO and the CFO are up to. On one company board, I was not confident in the CEO and his team. On another occasion, when I was appointed Chairman of Smith & Nephew, my priorities were twofold:

- *To have a top-class board representative of the company's industry sectors.*
- *To provide for succession for both myself and senior management.*

At Smith & Nephew, I now have a multinational board of directors that meets six times a year. It has strong American representation, and its members have relevant pharmaceutical and industrial experience. John Buchanan, my successor, is already on board. John, having been CFO of BP, brings experience from a very big company.

As retirements come up at Smith & Nephew, we shall also refresh the senior executive team. We are a good company, but we're constantly striving to be a great company. The only way you can become a great company is to replace people, including yourself! It is important to keep raising the bar. Part of my role is to help attract great people to a company which is ethically driven, proud of its products, and brings an ethos of high integrity to everything it does.

Corporate governance

The corporate governance model in the Netherlands is run on the two-tier board structure – a non-executive supervisory board that is clearly separated from the executive management team. The Dutch model, of course, applies to the boards of Aegon and KPN.

In the UK, where Smith & Nephew is based, we have a single board, but I still try to separate the non-executive and executive roles. The chairman has to give the CEO room to breathe and mustn't get involved in operations. For this reason, I don't believe the CEO of a company should ever become the chairman or non-exec in their company, since they're already too involved. It is appropriate for the chairman to advise on strategy and to act as a sounding board.

I'm Chairman of the Audit Committees at two leading Dutch companies: KPN and Hagemeyer. Prescribing what the Audit Committee should or should not do is a major issue. For example, one of the things to come out of Sarbanes-Oxley is the "whistle-blower" procedure. One of my companies had a much-publicized issue; we had to immediately set up an investigation, hire forensic accountants, bring in outside lawyers, review what went on, and then deal with the outcome. As Chairman of the Audit Committee, this created much additional work over a concentrated period of time. It also put us in direct conflict with management, which was defending itself.

If you are on the Audit Committee you are a delegated part of the board – jointly and severally responsible. You have to get at the truth. Potentially, this can damage the relationship between the non-executives and the executives. So it's important that any actions taken are consistent with company values, but also consistent with relevant international and, often competing, local regulations and jurisdictions. Undoubtedly, due to increasing regulations, the non-executive role is getting tougher!

The role of the CFO is crucial in the interface between non-executives and executives. The CFO now has to be ambidextrous – on the one hand reporting to the CEO, on the other, to the Audit Committee. The CFO has to have an open channel of communication to the Audit Committee on any matter. This is not disloyal to the CEO; it is good governance. It's in everybody's interest. It's also essential for transparency.

Inside the company – on the question of whether divisional CFOs should report to the group CFO – I believe that the group CFO should have the final say in the way in which the finance function is run across the company.

The impact of regulation and standards

What do you learn from scandals like Ahold's? As CFO, you have to trust, but you also have to verify! This was a wake-up call to manage cash: Ahold needed cash forecasts, cash control, and management needed to worry about where the cash was coming from to stay in business.

Turning to Sarbanes-Oxley, in well-run companies, the controls should already have been in place and further regulation shouldn't have been necessary. For example, when I was at Philips, we had what we called a Document of Representation – a sign-off by the CEO and CFO of each business unit of their results. But the CEO would typically rely upon his CFO. Under SOX, the CEO has to satisfy himself with documentary evidence.

What do I think of IFRS? It's the right way to go – it's setting a new benchmark for consistency. However, I do know that American companies would find it difficult to give up US GAAP. But if we can come close to bringing the two sets of standards together, then the reconciling items are less distorting – and we'll move much closer to one version of the truth!

As the effects of accounting volatility – bookkeeping rather than real cash – are introduced by the new accounting standards, they are likely to be discounted by investors. More and more investor attention will be on free cash flow per share. As a trend, you want to sustain your dividend stream based on your free cash flow rather than asset valuations. Cash, unlike profit, cannot be manipulated.

The group CFO is the one person in the company where everything comes together – for example, the annual report and accounts – thereby ensuring everything across the organization is in balance.

I really worry about attempts to value intangibles. For example, to gross-up a company balance sheet to value both organically grown brands and those acquired would inevitably be arbitrary, subjective, and open to criticism. We have to live with the inconsistencies of valuing intangibles – but it's imperative that a company publish a list of brands to inform readers about what they're investing in. This intangible value should be implicit in the share price.

You can always debate: What is fair value? What is market value? The standards are evolving. If we have to report more information than the existing standards require, then we have to keep open the possibility of publishing further regulated supplementary reports. This will help provide better transparency. Anything that helps put performance in perspective and make the results easier to read has to be encouraged! However, more information is not necessarily better.

Despite the negativity surrounding the cost and confusion of the new regulations and standards, one message comes out loud and clear from the chairmen and senior NEDs interviewed for this book: corporate governance is improving. And it needed to improve.

Nevertheless, there is generally a feeling that codes of corporate governance conduct should be combined across countries, initially across Europe and, ultimately, with the US. Companies are global, investors are increasingly global – so why not?

However, the CFOs we interviewed are not so supportive of what's happening with accounting standards. IFRS is seen as a confusing mixture of different accounting conventions – fair/market value in some respects, traditional historical cost accounting in others. There is also concern that individual countries will have their own interpretation of the standards, which are often difficult to apply in practice. Ultimately, most CFOs support the ideal of one global GAAP. However, the *principles-based* approach coming from Europe is generally preferred to the *rules-based* approach in the US.

As implementation of the new Sarbanes-Oxley regulations (SOX) and IFRS accounting standards settle down, more and more CFOs and their companies are likely to see beyond the initial one-off costs to the longer-term benefits. Experience will also grow in terms of what's important during implementation – for example, key controls – and what isn't.

As the stock markets recover, and as the world's economies become much stronger and more sustainable, CFOs are now turning their attention away from the scandals of the past and away from the negative aspects of the regulation. The fundamental issue that concerns them most today is how to play their part in creating value and growth.

CREATING VALUE AND GROWTH

Earlier CFO books[1] focused on the shift in finance functions from transaction processing to decision support. This comes through very strongly at GE. Finance functions are shrinking as a result of technology and the inexorable trend towards shared services, off-shoring and, in some cases, outsourcing. The emphasis continues to be on higher value-added decision support. Finance functions generally are investing heavily in developing their analytical and best-practice capabilities to support the business.

However, until recently, CFOs have been overtaken by events – the fallout from the spectacular accounting scandals, the resulting regulation, and a general tightening up in governance, control, and reporting. The changing shape of the finance function, from the late twentieth century to the present day, is illustrated in Figure 1.3. What's different is the increased attention being given to risk and regulation – and the emergence of an entirely new reporting function: sustainability, social responsibility, and corporate citizenship.

In Figure 1.3, the finance function of the 1980s is portrayed as a relatively fat pyramid, emphasizing transaction processing and lightly pro-

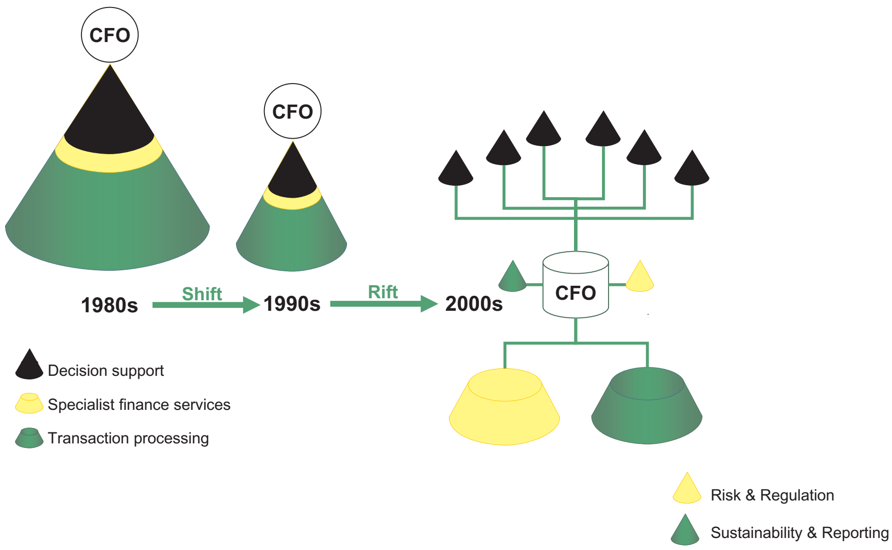

Figure 1.3 *The changing shape of finance*

moting decision support. In the 1990s, finance-leveraged ERP systems became more compact, with leaner transaction-processing operations and a greater focus on performance management. At the turn of the century, as explored in the book *eCFO: Sustaining Value in the New Corporation*,[2] the CFO became the center of a web of relationships managing the value of the extended enterprise.

Today, as we discuss throughout this book, the focus is not only on value creation but also on new dimensions of "*risk and regulation*," and the new function for "*sustainability and reporting*." We devote our last chapter to this latter, much broader specialty, which is being driven by:

- Corporate governance: the personal sensitivity of board directors, be they non-executive or executive, to the need for absolute and total compliance – and their drive to be seen externally as good corporate citizens.
- Reporting and transparency: increasingly, either through legislation or investor pressures, companies are required to report on key non-financial information – the source of future value.
- Reputation and ethics: the growing awareness of the importance of a much broader group of stakeholders of the need for responsible corporate behavior, and for management practices that reflect the highest standards.

When polled over the last 12 months, the views of senior finance executives involved with the Value Network Initiative (summarized in Figure 1.4) show that two issues now rank very high on their agendas: the impact of regulation, and growth and sustainability.

The following trends have been identified, based on analysis of change programs in corporate finance:

- The importance of benchmarking shareholder value performance in better understanding value drivers – and the increasing reliance on key performance indicators (KPIs) for managing value.
- The growing proportion of a company's value tied up in its intangible assets – such as intellectual property, brands and R&D, customers and talent.

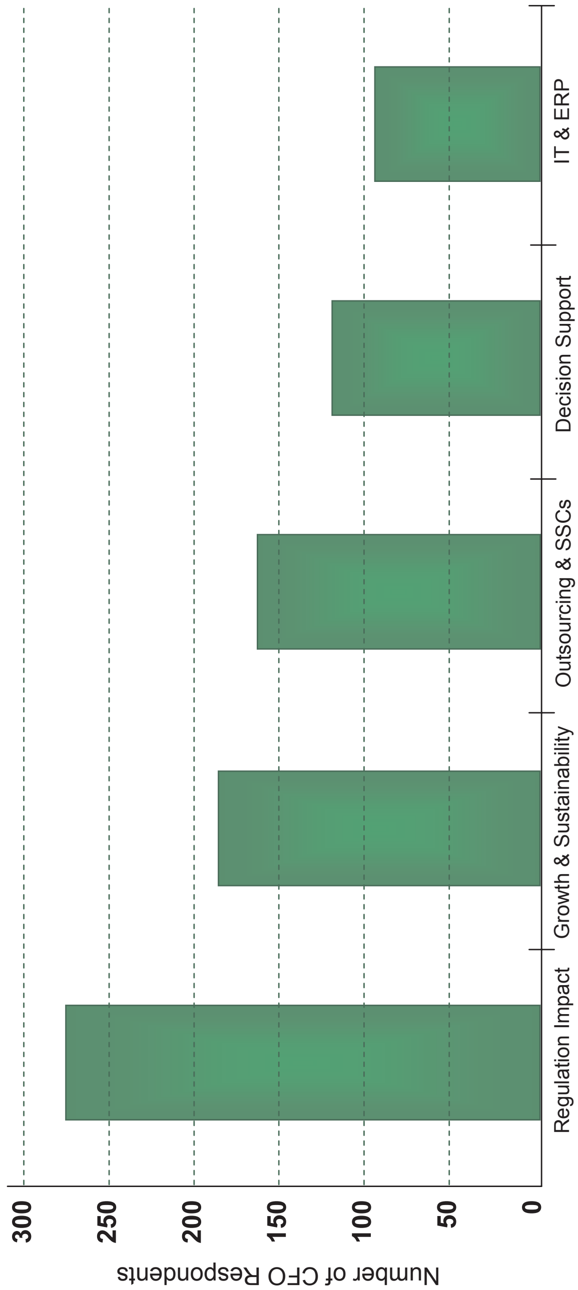

Figure 1.4 *Value network initiative: top CFO issues*

- The increasing importance of, and rigor behind, non-financial information – and the responsibility of the CFO and the finance function for its authenticity.
- Changes in financial management processes: looking forwards rather than backwards, coping with ever-increasing degrees of uncertainty, and extending risk analysis from a relatively narrow financially oriented discipline to enterprise-wide risk management.
- Increasing organizational and structural flexibility: taking advantage of the trend towards shared services, identifying which parts of the value chain should be insourced, which should be outsourced – and going either near-shore or off-shore to achieve lower costs and find new talent pools.

When individual members of the VNI ranked themselves against best-practice criteria on a scale of 0 to 5, all felt they had a lot to do in performance measurement, analytics, intangibles, and connecting strategy with operations. The results of this benchmarking are reproduced in Figure 1.5.

The finance functions of many of the companies surveyed are now developing their decision-support capabilities. This is a relatively new field of specialization and it raises many unanswered questions: How do you incorporate shareholder value thinking in your management and financial processes for planning, performance, and creating incentives? What is best practice in growing and managing the value of intangible assets? Management gurus gave us the *thinking* behind the value chain, but they didn't tell us how to *value* it in practice!

Consider next what Jan Hommen said just before he retired as CFO of Philips. Jan is currently very active in leading Dutch companies – as Chairman of the boards of Reed Elsevier and TNT, and of Ahold's audit committee, and as a board member of ING.

VALUING THE VALUE CHAIN

Jan Hommen, former CFO of Philips

Philips has been transitioning from a multi-purpose structure to a more single-purpose organization. Its new strategic focus will be on "healthcare," with an overflow into "lifestyle" products supported by our strong technology capability. We've made

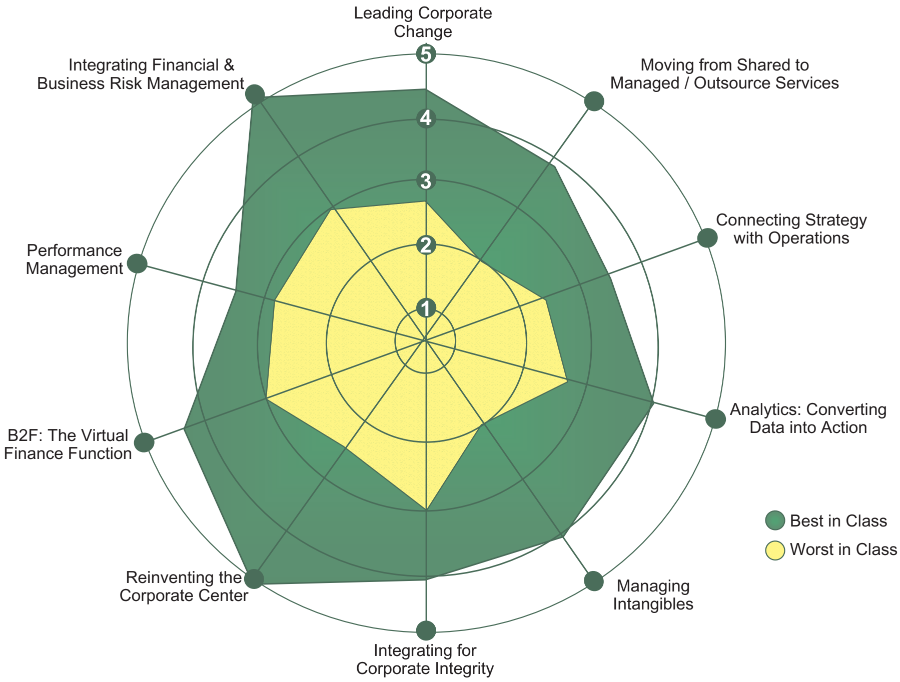

Figure 1.5 *Best practice implementation gap*

a number of acquisitions in healthcare already. These are now integrated and working quite well.

Unfortunately, the market has not recognized the full value of our new strategy. So there should be significant upward potential, if we can execute this strategy well and convince the market of our capability and determination to do so. This will require:

- *Finding the right acquisitions, integrating them quickly, and making the earnings accretive, along with organic growth.*
- *Liquefying financial assets on our books and using them to optimize shareholder value. Also, we still have a number of activities in Philips that are not highly cash generative – these either need to be disposed of or de-risked.*

This strategy will make our earnings much more consistent and predictable, and will simplify our organization and ways of working. We are also improving our forecasting accuracy and reducing the volatility in our earnings by making costs variable.

Shareholder value analysis

When we take "the sum of the parts," as analysts do, it's greater than the current share price. We value each of our major business units by benchmarking their value drivers against those of their competitors – and then working out the business unit proportion of the group's total shareholder value.

Analysts punish us with a conglomerate discount of approximately 20%. The rationale for such a discount is not always clear. But the real question is how to convert this into a premium. That is the management challenge at the group level: to add value to these businesses, rather than destroying it!

How are we addressing this undervaluation? We need to make more of the "One Philips" idea – leveraging the benefits of being a large company with a strong brand, special distribution capabilities, and innovative technology applications. This needs to be reflected in better performance for the group as a whole.

Optimizing value in the value chain

We recognize that value is generated by being a successful technology company and through our investments in research, product creation, design, marketing and branding. Also there is significant advantage in having a low-cost, but high-quality supply chain and in strong channels to market.

Increasingly, however, we are finding that, in some areas, being in manufacturing is less and less attractive, especially as cut-throat cost competition from the East continues to bite into our value. We're constantly trying to maintain an optimal balance. Excellence in all areas is not always possible, so we need to find partners and alliances with special capabilities and the right cost structures.

In each business unit, we try to understand how the "value" in the value chain is built up. We define where the principal economic control points are in the chain. At these control points, we like to have strong competitive positions – where the value created is greatest. In some parts of our business, time-to-market is critical for competitive advantage. In others, the quality of customer insight can be more important than speed.

The medical business is a good illustration: we place a high value on our relationship with physicians. Since they are effectively our customers, we have to better understand how they work and what they need. By contrast, value created in the consumer electronics sector is moving either upstream to the design and intellectual property of semi-conductor chips or down the value chain to distribution, marketing, and the retailer. Value in the middle – in manufacturing – is being squeezed.

R&D and finance

Finance is in a good position to help define the right measurements and performance yardsticks for innovation management. We measure innovation as the proportion of our sales generated from new product introductions over the last two years. In the medical division, 62% of our sales are generated from products introduced in the last two years.

Finance staff in the R&D area need a good grasp of technology, but they also need to be savvy business people who can work with marketing and sales in appreciating what the marketplace will require tomorrow. The finance function helps make R&D economics visible to management, analyzing and presenting the value opportunities going forward. Then it identifies the necessary investments required to exploit them. Not an easy task!

Finance and standardization

When I first arrived at Philips, finance was mostly an administrative and accounting function with little real decision-support capability. As a result, it was very difficult to see and predict the total financial picture. We had inadequate information on which to base reliable forecasts, since the focus was backward rather than forward, and there was very little in the way of risk management. The product divisions had a great deal of freedom to decide on strategy. There was hardly any coordination across the group on capital allocation, R&D investment, systems or marketing. It was every one of the thirteen divisions for themselves – with little or no synergy among them.

We have taken hold of this "monster" by simplifying the business and cutting back on our structural complexity.

We have rationalized our excessive number of business units from approximately 160 down to 40; the number of divisions from 13 down to 5; the number of ERP systems from 600 down to about 40; and the number of employees from 280,000 *down to 160,000. Underneath all this, we changed from processes that were predominantly organized into vertical functional silos to horizontal business processes that are now more integrated. We also standardized many of these processes across the company.*

Today, we have a fundamentally different kind of company. Rationalization has delivered significant efficiency improvements. It's also meant much quicker decision making from the top to the bottom of the company – and a more forward-looking management supported by better planning.

Finance agenda for 2006

Finance has been a major catalyst for all these changes. In 2003, we started a "Best in Finance 2006" program. Using benchmark studies, we proved that we were too focused on low value-added processes. We designed a plan that was extremely well received by management: we were to be not just "best in class" in terms of our finance cost base, but in the processes and results we were to achieve for the business. In finance, we now see ourselves as the co-pilot of the CEO and the business partner for the rest of the company.

The highly successful Philips 2006 finance program focuses on five major initiatives:

- **Portfolio management** – supporting the strategy of the business in innovating and developing new products, making selective acquisitions and divestments, and generally maximizing value through value chain optimization.
- **Analytics** – increasing capability to better understand margins by products, and where and how profits are made.
- **New systems** – implementing enterprise-wide applications that are integrated with ERP and data warehouse resources for group financial consolidation, planning, and performance management.
- **Forecasting** – making improvements to the rolling forecast process, identifying value drivers in greater granularity on a monthly basis, and understanding the impact on the next quarter's performance.

- **Accounts close** – speeding up the time taken to close the monthly accounts and to produce detailed financial information.

Later in this book, we explore many of the issues raised by Philips – for example, how companies are optimizing the value of their R&D pipeline, how they are standardizing their finance operations, and how they are implementing best practices in financial management, such as rolling forecasts.

There is one company, however, that stands out from the many interviews we've conducted during our research: Diageo. Of particular interest are its decision-support function and global shared service center. We cover these aspects of Diageo's finance agenda in greater detail in subsequent chapters, but here, we interview Nick Rose, the CFO. He brings a number of the VNI themes together *as an action blueprint for others to follow!*

SHAPING THE NEW AGENDA

RAISING THE BAR

Nick Rose, CFO of Diageo

For Diageo, total shareholder return (TSR) – share price appreciation plus dividend – still remains the best and most fundamental financial indicator for measuring how we're creating value for shareholders.

What we've learned in the last five years is that it is very difficult to sustain your TSR performance in the top quartile of your industry peer group. If you take a three-year rolling view, then we've achieved a top quartile position on some occasions. But it's very difficult to sustain that performance as your share price adjusts to this new base performance level.

Your peers are always trying to raise the bar and share prices are often subject to market forces that you're not in a position to influence. So this is a very challenging benchmark, and we're never complacent. Although we're number one in size in the global alcoholic drinks market, we're always learning from other marketing-led companies with great performance track records, such as L'Orèal and Colgate Palmolive.

It's critical for finance to help Diageo to beat the competition! To improve our efficiency and effectiveness, we've had to be rigorous in defining our structure for the company as a whole and in how the financial processes should work to support it – at a global level, regionally, and in local markets. This has certainly influenced how we've organized the finance function.

Global business support

At Diageo, we now embrace the concept of global business support. We used to have a lot of overlapping effort among head-office functions. Today, we only have one integrated team, which supports the local market when required.

In fact, my own role as CFO – at executive committee and board levels – has also broadened: I'm now responsible for strategy, supply chain, and IS, as well as finance. We're seeing the benefits globally, as well as locally, of integrating these functions into one coordinated service.

We're clearer about where the finance function can add value to the "front-end" of our business, which is all about consumers, customers, sales and marketing. We've built a shared service center in Budapest to manage key processes globally. Our goal: to liberate the front-end of the business, including the finance people who support it.

We started with shared services in Europe and have extended this to include North America and Australia. All time zones are now covered. Having one global SAP platform helped and our migration to one global shared service center in Europe has not been as difficult as it might have been. But I'm not saying it's been easy!

Out of this organizational change has emerged a new support function that we call global business support (GBS). GBS has three core capabilities: decision support, strategic planning, and change management. Together, they help drive performance improvement for the front-end of the business and provide it with integrated support.

The upside of regulation

Against the background of accounting scandals and reporting mishaps elsewhere in the corporate world, we too – like companies such as BP and Shell – have reviewed our internal reporting lines and controls and made a few changes.

I always try to create a positive outcome in responding to, for example, SOX regulations and corporate governance changes. They can be demoralizing. But if these *changes lead to a stronger company foundation, then you can create a positive environment. Today, for example, the general managers who run our markets don't have to worry about control glitches; they can concentrate on beating the external competition. Another chance to liberate the locals!*

I chair the audit committee of another company, Scottish Power. Currently, we're focusing on what we can really do to add value to the company, as opposed to just what's required by law. The real challenge for audit committees – where the non-execs' personal reputations are at risk – is to avoid excessive demands for detail and bureaucratic control. You need to "see the wood for the trees" and strike the right balance between risk and reward.

There is no black and white answer to the question: how much centralization? It's a mixture. At Diageo, by centralizing what we see as global processes, we've put the pressure on business performance: We're encouraging local-market units to improve by putting them in a stronger competitive position.

After years of experience of dealing with this issue, it is vital to be clear on the dividing line between what should be central and what should be local. You want to focus the energy of your people, not on arguing about where to draw the line, but on how to create value for the organization as a whole.

Sustainability and social responsibility

Most CFOs have to focus on the sustainability of earnings, on growth over the longer term – ten years or more. They wrestle with balancing longer-term investment against the short-term pressures imposed by the market. However, stakeholders today are using a wider variety of measures – non-financial as well as financial.

The ability of a company to deal with governmental, environmental, social, and community issues – being a good corporate citizen – is under increasing scrutiny and regulation. These pressures and the risks they raise are real – not academic – and may affect whether or not a company will be around at all in ten years' time! For example, if you take company pensions, there are now many more stakeholders involved and there's much more today for the CFO to worry about than just the financial implications.

In our industry, alcoholic beverages, we have to recognize that alcohol abuse is a big and controversial issue: you only have to pick up the newspaper to see stories of irresponsible drinking. For Diageo to be sustainable, we have to be proactive in *promoting responsible alcoholic consumption. Consequently, there has to be a clear link between sustainability and long-term shareholder value.*

As far as performance reporting is concerned, I believe this will continue to develop along a more integrated route – bringing together more of the broader, non-financial information related to future sustainability together with the financials. The external stakeholders, including investors, are likely to want to cross-relate the non-financial to the financial information to ensure consistency.

We're working on how best to integrate the two different sets of data collection routines involved into our financial system for our year-end reporting. I can only see this going one way: By integrating sustainability information into our statutory financial planning process, putting it all through the filing assurance committee – our year-end clearance process – we can best assure the quality and consistency of the broader picture.

What's ahead?

As CFO of Diageo, what's on my agenda for the future?

- *Business performance: How do you beat your competition on a sustainable basis and beat the expectations of your shareholders?*
- *Business risk: How do you deal with the broader picture, from the sheer weight of governance and regulation to providing the best growth environment possible?*
- *Business process efficiency: How do you continue to take out cost, looking again at outsourcing and the role of the Far East in the entire business supply chain? What should be "in" and what should be "out"?*
- *Tracking our shareholders: Who will they be in five years? Hedge funds are having an impact on the ownership of major companies. What does this mean for investor communications and performance expectations?*

Not all CFOs have gone as far as Nick has with his finance function: Diageo's decision-support function is quite advanced and its global shared service center in Budapest is state-of-the-art. And Nick himself, in addition to leading finance, now has quite a broad role: he's also responsible for strategy and IT, as well as Diageo's supply chain.

In the chapters that follow, we cover in greater depth what CFOs and senior finance executives are doing to address their twofold challenge: coping with regulation driving while pursuing growth and innovation.

In Chapter 2, we review some of the structural models that are emerging in response to the increased emphasis on control and regulation – and offer choices for how far CFOs need to go. Chapter 3 sets out how to get there.

Subsequent chapters focus on the role of the CFO in managing the drivers of value creation in a regulated world. Those drivers are: intangible assets (Chapter 4) and innovation (Chapter 5). Next, we cover the new financial management disciplines, specifically forecasting (Chapter 6) and how one company, Unilever, brings these disciplines and tools together in a business-partnering culture (Chapter 7).

In the last section of the book, we focus on the future: how global connectivity and seamless support are reshaping the ways that companies around the world do business (Chapter 8); how companies in various industries are trying to benefit from a positive approach to risk and regulation and where this is all likely to lead (Chapter 9). Finally, we make the link between shareholder value, social responsibility, ethics, and sustainability (Chapter 10) – a new discipline for a new world!

STRAIGHT FROM THE CFO

Summarized below are the key insights emerging from the CFO research program on which this book is based. For ease of reference, these are arranged by chapter.

- **Reshaping finance**

  Centralization: make choices about how far to go. Strengthen reporting lines. Promote consistency and accountability across the enterprise. Standardize where possible. Optimize processes. Reduce complexity and streamline structure. Learn from private equity.

- **Making change happen**

  Know your starting point – it's unique! Lead from the front: you're the key sponsor and change agent. Pull *all* the change levers. Take *all* the stakeholders with you. Attract and nurture fresh finance talent. Move from CFO to COO!

- **Releasing intangible value**

  It's more about execution than valuation. Find the missing half of your balance sheet! Know how different intangible assets contribute value. Select the right valuation techniques. Move from the back office to the front.

- **Driving growth and innovation**

  Make innovation an "all-the-time," everywhere capability. Be honest: do you really encourage breakthrough ideas? Make it your job to transform the internal business model and align it with the broader innovation agenda. Develop an innovation scorecard. Become the "value architect." Work with external customers for a win-win.

- **Looking *forwards*, not backwards**

  Expect the unexpected. Close the strategy gap. Harness the value in the value chain. Connect the dots: integrate your processes for performance management. Roll those forecasts!

- **Innovative business partnering**

  Take the plunge and throw away the comfort blanket! Create a business-partnering culture. Go for best practice, not just good practice. Learn from the outside, not just the inside. Trade war stories and celebrate successes. Energize and share through a finance academy.

- **Promoting global connectivity**

  Flatten your world! Stretch the shared services envelope. Aspire to seamless support. Go near-shore or off-shore. Build a worldwide center: make it into a business in its own right. Develop global partnerships. Create value by outsourcing.

- **Leveraging risk and regulation**

  Look for the benefits in SOX. Consider what IFRS conversion means to your business. Where you can, integrate regulatory initiatives to avoid implementation overload. Weigh the possible benefits of dual accounting. Assess your risk appetite. Make the case for a separate enterprise-wide risk discipline. Appoint a CRO!

- **Becoming a "good corporation"**

  Link ethics to shareholder value. Lead the charge for corporate responsibility. Broaden your corporate reporting – test your indicators against industry benchmarks. Consider the triple bottom line. Spread the word. Do a sustainability health-check with stakeholders. Become the "good corporation!"

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