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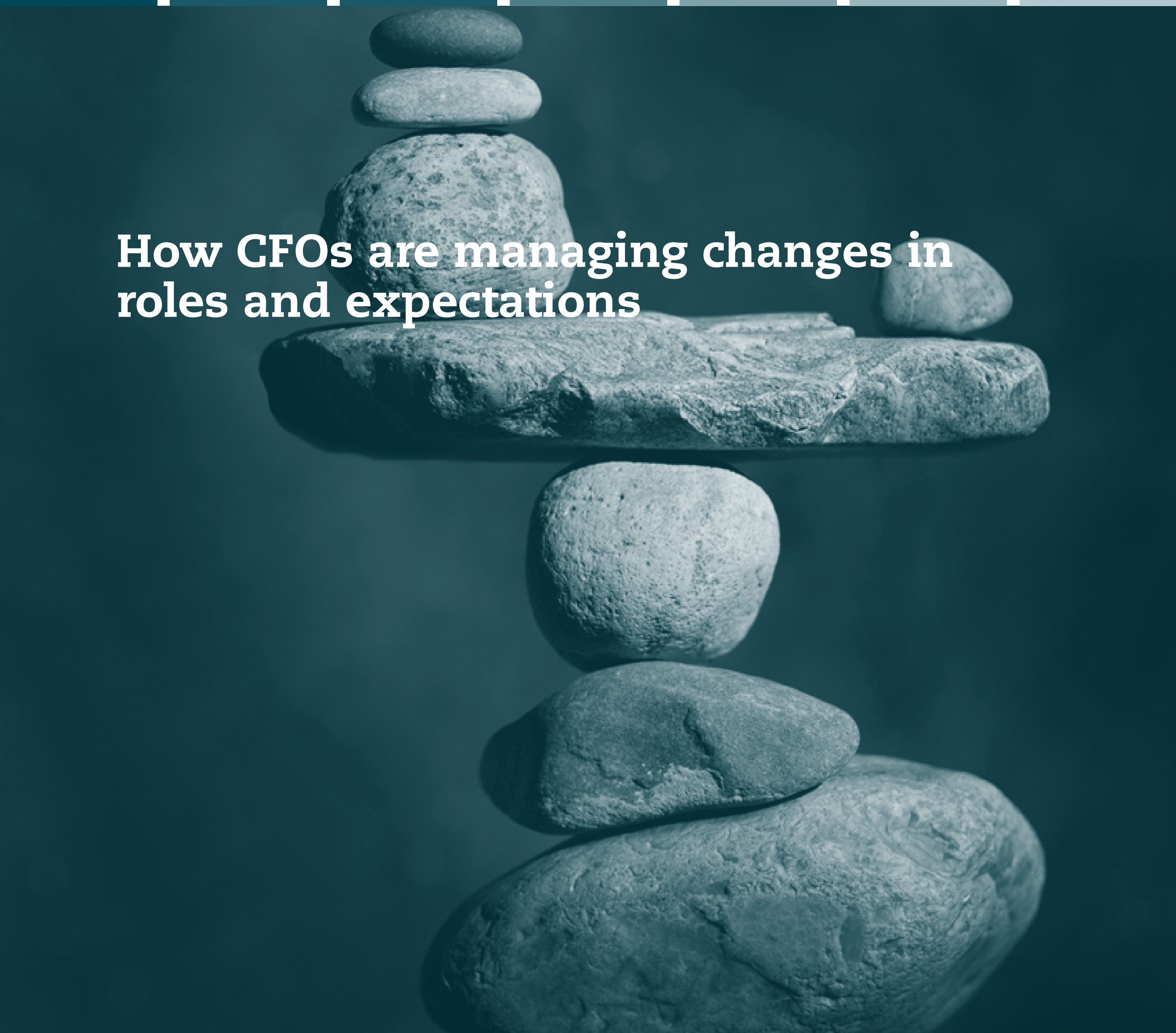
How CFOs are managing changes in roles and expectations



Contents

Note: Throughout this report, we refer to Chief Financial Officers (CFOs) in the US manner. However, our supporting research was conducted in both North America and Europe, and most of the analysis applies equally well to British Financial Directors and other Europeans in equivalent positions. Similarly, we have used 'MBA' and 'CPA' as generic terms for managerial and accounting qualifications.

February 2006

1. Executive summary

The traditional role of the Chief Financial Officer (CFO) as custodian of a company's financial stability has become more nuanced and complex in recent years, as financial reporting and compliance responsibilities are balanced with strategic business support. Mercer and Russell Reynolds Associates used more than 60 in-person sessions with public company CFOs and key stakeholders in North America and Europe and wide-ranging desk research to explore how CFOs have managed the impact of a rapidly changing business environment.

External pressures

Changing pressures on CFOs

- Capital market intensity
- Investor skepticism of CFO messages
- Increased focus on buy-side portfolio managers
- Regulatory changes that strain resources
- Heightened Board involvement in reporting and business review
- Less advisory and collegial auditor relationships
- Greater complexity caused by underlying business dynamics

Equity and debt markets have become less forgiving. Regulatory changes affecting research recommendations and new credit instruments provide a more transparent view of underlying securities' values. Investors turn over portfolios more rapidly and have less faith in reported financial data in the wake of recent accounting and governance scandals. The result is increasing intensity of engagement between the CFO and the capital markets.

Recent corporate scandals have also driven tougher regulatory requirements that put more demands on the CFO, Chief Executive Officer (CEO), and Board. Most prominent is the US Sarbanes-Oxley Act (SOX), although companies based in other countries are beginning to face similar tightening in regulation or accounting requirements. For the Finance function, such changes mean that a fundamental focus on getting the numbers right and ensuring appropriate controls is again the first order of business.

Regulatory changes have also affected the CFO's relationship with the Board and with auditors. Board interactions have become more intense, with Boards adamant on 'no surprises.' Audit Committees, in particular, require more frequent and comprehensive updates and education. The Board has also become the de facto client for external auditors, whom the CFO can no longer expect to provide the degree of advice or guidance previously enjoyed. Auditors have grown more rigid about discrepancies and less willing to commit themselves on controversial issues.

CFOs are also spending more time on investor relations, often by talking directly with buy-side analysts and portfolio managers, in order to familiarize investors with the company's strategy, business model and economics, and underlying numbers.

On top of these concerns, achieving strategic objectives – mitigating risks, seizing growth opportunities, and creating value – has become a significant challenge. Technological change and globalization have reduced the half-lives of business models, requiring more intense strategic and tactical engagement. As firms expand their operational and geographical footprints, the role of Finance is expanding beyond assessing opportunities and threats to managing complex operations and new business risks.

A new profile

These changes in market dynamics, stakeholder relationships, and business complexity have affected the profile of the executives charged with managing them. A new, better-paid breed of CFO is emerging as more CPAs and MBAs fill out the ranks and more companies look outside to fill the top Finance post. As the role has expanded, CFOs often struggle to find the right balance between compliance efforts and business support. The market increasingly values specialist skills that sometimes outweigh the value of internal knowledge.

The market's shift has also accelerated turnover in the CFO role, both in terms of promotions and resignations. On one hand, the CFO role is viewed as good preparation for other senior positions within or outside the company. On the other hand, it has become a 'hot seat' for performance- and controls-related failures. The tension between the risks and rewards of the role has driven out some incumbents and may be deterring qualified candidates from the position.

Pragmatic solutions

In the face of higher expectations and a mandate to restore trust, the CFOs identified four areas for managerial attention: improving stakeholder communications and relationships, demonstrating leadership in Finance, building a high-performance Finance organization, and developing systematic approaches to managing risk.

Improving stakeholder communications and relationships: The need to build or rebuild trust places a premium on communications about the workings of the firm's financial operations, operating environments, and the parameters of risk and performance in its industry.

CFOs also are strengthening internal control processes and are more actively directing the flow of information. Since Boards have become less tolerant of surprises, CFOs have been adjusting processes and technologies to ensure that unanticipated developments are flagged and addressed early on.

Demonstrating leadership in Finance: Leadership is manifest in various ways, such as establishing a firmwide culture of compliance and control, embedding Finance staff within business units, and disseminating management science and uniform analytical standards throughout the organization.

One effect of these measures has been to expand Finance's influence, raising the need to strike an appropriate balance between effectiveness and independence. For example, CFOs must be in sync with their CEOs, yet they also have to retain the independence required by fiduciary duties to the Board.

Management solutions for CFOs

- Focus foremost on superior financial reporting and controls
- Rebuild and rebalance the Finance function, particularly the Controller and Deputy Controller roles
- Communicate actively with the Board and Audit Committee
- Develop rigorous processes to avoid surprises
- Establish and enforce a culture of compliance
- Build a partnership with the CEO
- Drive management science and better decision-making throughout the organization
- Select the right audit partner
- Hire, retain, and develop talent
- Embed Finance talent throughout the organization
- Redesign work to focus on higher-return activities
- Improve understanding of and preparation for business risk

Building a high-performance financial organization: CFOs with whom we spoke agreed that the starting point for restoring trust is the sound execution of fundamentals and the shoring up of key Finance capabilities. Many Finance headcounts are rising to comply with new regulations and to address the expanded CFO and Finance roles.

CFOs cannot deliver effectively against their broad mandate without a staff that offers the necessary leverage and array of specialist skills. Many firms are expending considerable effort on recruiting and developing talented Finance personnel, and they are striving to ensure that those personnel work on activities that genuinely create value.

Developing systemic approaches to managing risk: CFOs would like to improve their organizations' ability to anticipate and plan for 'unknown' risks, thus avoiding future surprises as far as possible. They expressed interest in exploring solutions to identify risks holistically and systematically, improve their organizations' ability to manage and respond to external events, and reduce uncertainty in future reporting.

This will require a shift in mindset away from the largely tactical focus of late, as many organizations deal with short-term compliance efforts and new stakeholder requirements. After the current wave of increased scrutiny has waned, CFOs expect to spend more resources on the strategic direction of their companies, lending their expertise to the challenges of value creation.

2. Introduction

We are taught what is known, rarely learn about what is not known, and almost never learn about the unknowable.

– Ralph Gomory, Scientific American, June 1995

What's the main role of a CFO? One provocative answer is that he or she has the job of ensuring that a company really knows what it thinks it knows – making sure the company understands and reports its financial position accurately, and minimising, as far as possible, the unknowns that make its position unclear.

In recent years, many CFOs have been called upon to extend their roles. Beyond the retrospective focus on financial reporting, they are being asked to provide more analyses of a company's future prospects – in effect, to reduce future unknowns as well as present and past ones. CEOs have been turning to CFOs to help them better anticipate risk and manage potential surprises; they are urging CFOs to deploy more thoughtful and sophisticated scenario-modeling techniques to harness financial and business data, and to help refine understanding of the unknown variables in competitive and financial markets.

Attention on avoiding surprises has been spurred, in part, by the past five years' accounting and governance debacles, which have made regulators and stakeholders more skeptical about financial reporting. In a more demanding compliance and reporting climate, many companies strain to cover the basics of financial reporting, as evidenced by the roughly 6,400 late earnings filing notices from public companies in the US in 2004, and the roughly 400 announced earnings restatements.[1] More intense oversight has added to the demands on CFOs even as the support traditionally offered by auditors has dwindled.

To better understand these developments, Mercer and Russell Reynolds Associates conducted more than 60 in-depth discussions, speaking with CFOs in a wide variety of industries, primarily in North America and Europe, as well as with equity analysts, portfolio managers, Board Audit Committee members, and regulators. Their insights, along with proprietary analytical research and client experience, form the basis for this report.

Footnote

1 SECinfo.com; Mercer analysis; Huron Consulting Group's 2004 Annual Review of Financial Reporting Matters. Comparable late filing notices for 2005 increased to 7560

3. Pressures on the CFO

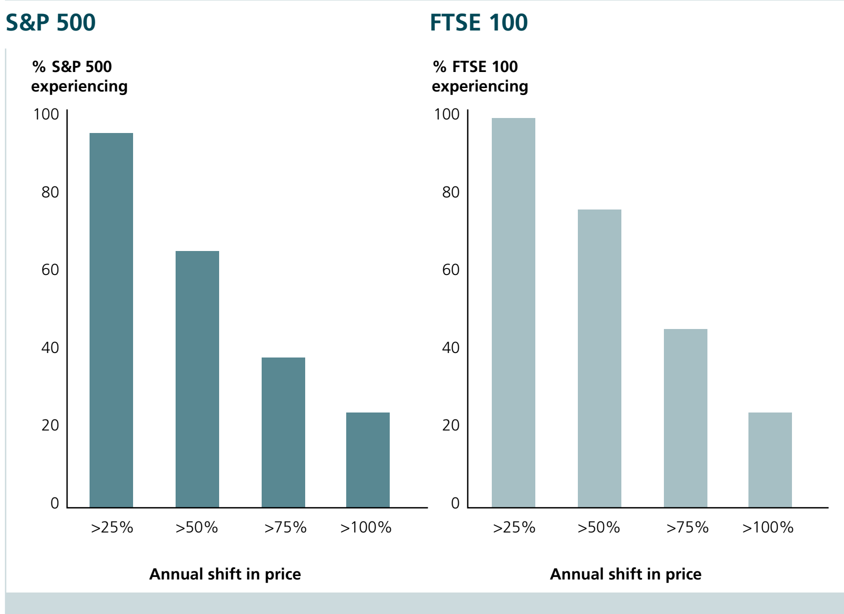
Market dynamics

Today's CFOs operate in volatile and fast-paced markets, as investors receive more information than ever before and act on it more quickly. Whether they call the current environment "challenging" or "energizing," the people with whom we spoke generally agreed that capital markets are more demanding of CFOs.

Capital market intensity poses an increasing challenge

Many CFOs, particularly in the US, said that rapid market valuation shifts in recent years had increased the pressure on managing the business. Roughly 40% of the largest companies in the US and UK experienced a shift of more than 75% in their share prices during at least one year of the period 2003-2004, as shown in Exhibit 1.

Exhibit 1: Significant movements in share prices, 2003-2004



Sources: Datastream; Mercer Analysis. Represents annual shift in 2003 or 2004

Note: High UK incidence driven by large 2003 shifts; in 2004 only a third had shifts > 50%.

These movements can be potentially ruinous and may require the CFO to step in whichever way the price has swung. A price that drops relative to the market requires explanation and damage control; a spike up raises questions of sustainability. Either way, the CFO stands as the company's spokesperson for explaining these issues to the satisfaction of the management team, investors, and employees.

In addition to increased long-term equity price volatility, debt markets also show increased variability, with a record number of 'double downgrades' during the recent downturn[2]. Increases in debt downgrades and sub-investment-grade issuance have also unsettled rating agencies and bond investors. In response, many CFOs are now spending more time communicating with these stakeholders.

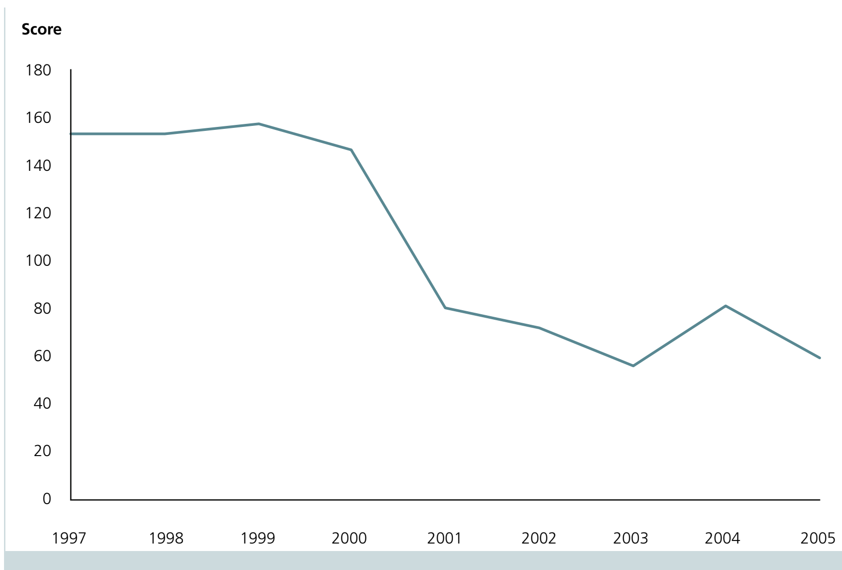
Investors remain skeptical of the CFO's message and trade more quickly

Market volatility arguably raises the importance of frequent, clear communications between CFOs and investors and other stakeholders, even though investors remain suspicious.

US investors, for instance, have become less optimistic in recent years following the collapse of the 'bubble economy' in 2000 and the wave of corporate scandals, which damaged confidence in corporate reporting and accounting (Exhibit 2). Nine out of ten investors questioned by UBS and Gallup in a July 2002 survey said they felt accounting issues were negatively impacting the market; 40% said that questionable accounting practices made them less likely to invest in equities.

Exhibit 2: Shaken confidence

US investor optimism



Source: Index of Investor Optimism, UBS and Gallup Organization.

Note: UBS/Gallup monthly poll of 800+ households focusing on seven macro and personal investment questions, including outlook on price of oil, housing market, etc. Questions are proprietary to UBS. Annual average of monthly polls.

Footnote

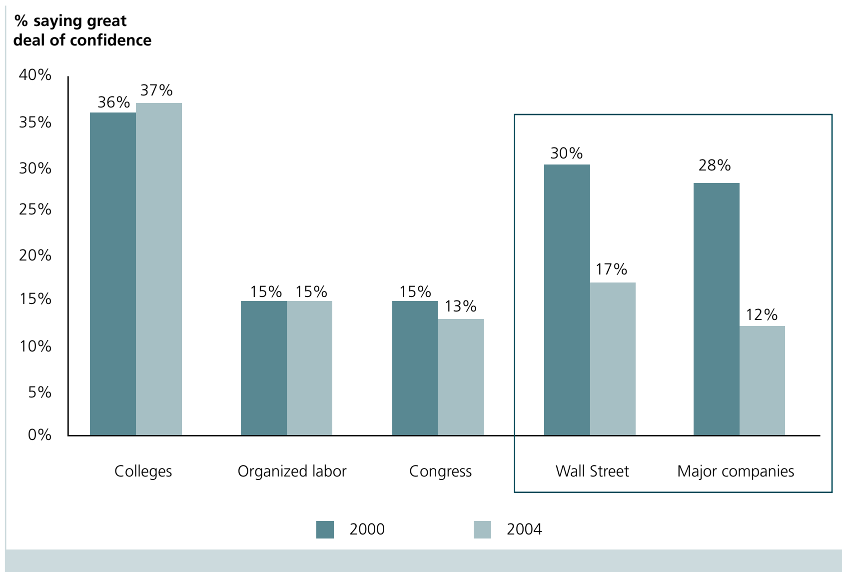
2 Volatility measured as standard deviation of weekly returns and reviewed over the past two decades. The volatility of the US S&P500 and European S&P350 indices increased, as did the volatility of A- and BBB-rated US bonds relative to US Treasury rates. Double downgrades measured as at least a two-notch S&P rating reduction. S&P; Merrill Lynch; Mercer analysis

The collapse in investor optimism reflects a significant decline of confidence, specifically in Wall Street and large corporations, as suggested by a recent Harris Institute poll (Exhibit 3).

Exhibit 3: Lacking trust

US Harris poll

Regarding the people running these institutions and organizations, would you say you have a great deal of confidence, only some confidence, or hardly any confidence at all in them?



Source: The Harris Poll, Feb 9-16, 2004

These issues are not confined to the US. Edelman, a global PR firm, conducted a 'Trust Barometer' survey in 2004 which found that two-thirds of Americans and slightly more Britons, French, and Germans cited "misleading communications including financial performance" as one reason that they trust companies less. Italians are even more jaded: 96% of the respondents to a 2005 survey said they did not trust the financial system, compared to 45% before the country's recent rash of corporate scandals.

The need to build trust is essential when investors can react quickly to new information on company performance. In 1980, it took just over 33 months for all the shares listed on the New York Stock Exchange to change hands; 20 years later, this turnover occurred in less than 14 months, and more recently has moved closer to 12 months.[3]

The fact that more than half of the daily equity volume on certain exchanges may now be traded by hedge funds exacerbates this trend; hedge fund managers are generally less inclined to take the kind of long-term views that tend to dampen volatility.

Footnote

3 New York Stock Exchange Fact Book 2001, BusinessWeek

CFOs are focusing on buy-side portfolio managers

For CFOs, then, communication is a high-stakes pursuit. Russell Reynolds Associates has found that CFO failure to communicate with investors in an open manner was an increasingly important factor in replacement searches during the second half of 2005.

CFOs have responded accordingly: Many CFOs spend considerable time explaining a company's strategy, business model, and story to institutional investors and other analysts through roadshows and conference calls. They are especially solicitous of investors with a longer-term perspective who find value in explanations of underlying business economics. While most consider hedge funds "a fact of doing business", some are concerned that aggressive trading positions can disrupt corporate strategies to achieve short-term ends. Some CFOs have dedicated efforts to getting out and speaking to the major hedge funds as a matter of routine. Yet, not everyone on the buy-side is satisfied; smaller investors report being frustrated by lack of access beyond the Shareholder Relations staff; others complain of inadequate disclosure.

Equity analysts, meanwhile, highlight the high standards of clarity and quality they expect in CFO communications. From their standpoint, the best CFOs build trust by demonstrating a sound grasp of operational details and delivering a solid track record of accurate numbers: "Nothing is more important to value than the integrity of the numbers," said one analyst. Once that trust has been broken, it is extremely difficult to regain; analysts said that it would take a long time to escape a perception of 'weak' numbers.

CFOs report that their relationships with sell-side analysts have become more formal, and often are delegated to Shareholder Relations teams. If sell-side analysts can't gain direct access to the CFO, they expect to deal with knowledgeable representatives who have attended key internal meetings and can answer questions directly. Otherwise, their interest dwindles. As one analyst put it: "There are many, many options for my time and resource dollars. If I can't get what I need, I'm not going to follow you."

In the UK, the switch from UK GAAP to International Financial Reporting Standards (IFRS) has created a need to explain and justify major changes to analysts. For example, one company had to explain why a £50 MM loss was transformed to a £1.3 BN profit under the new standards; others have produced two sets of numbers so that analysts can understand how they compare.

Regulatory and stakeholder demands

In addition to these market factors, the control environment for companies and their CFOs has also changed.

Regulatory changes have strained resources

For one thing, regulators have imposed greater scrutiny of companies' financial activities and reporting through new regulation, associated audit controls, and tougher enforcement of existing rules.

This phenomenon is global. Canadian firms anticipate new and revised control-oriented regulations in the next year or so, while many firms in the European Union (EU) have entered their first reporting period under the new IFRS. UK companies are preparing for their first new-format Business Reviews in line with the provisions of the 2003 EU Accounts Modernisation Directive. Further EU regulation is also possible.

The most widely publicized aspect of the regulatory crackdown was the 2002 Sarbanes-Oxley (SOX) bill for firms filing in the US. SOX seeks to increase corporate responsibility and tighten financial reporting requirements, strengthen auditor independence, and increase oversight. Its most notable feature, Section 404, requires management to testify that there are sufficient control structures and processes in place to ensure accurate financial disclosure.

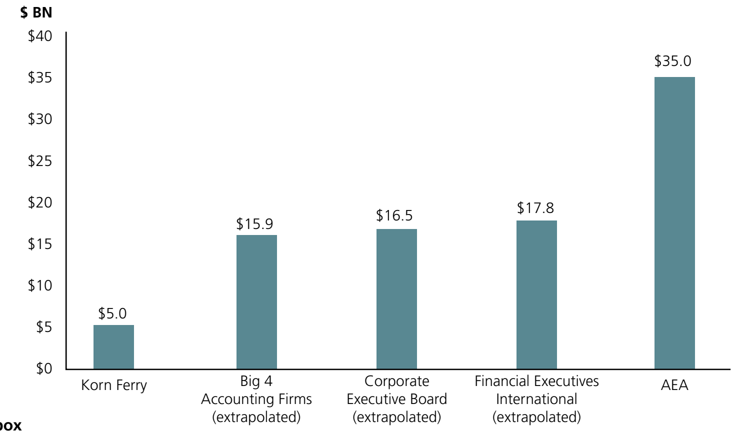
Finance organizations in faster-growing and more dynamic industries, such as information technology, may have been catching up to the growth of their companies. In such cases, SOX's reporting and documentation requirements represent a heavier workload. SOX is not universally regarded as a burden, however. At companies subject to close regulatory scrutiny, such as utilities, or where business models have remained relatively static, CFOs said that SOX has made little change.

Indeed, several CFOs indicated that increased regulatory focus on compliance and control has brought benefits that would have otherwise taken years to implement. One described himself as "positive on SOX – although there was lots of pain, it forced us to document processes and tackle the integration of legacy systems. We wouldn't [otherwise] have known which controls were broken." Others welcomed having their colleagues finally reviewing documents and internalizing the new reporting. "It's amazing how much more attention people pay when they have to sign things," one CFO said.

Despite the benefits, many CFOs expressed frustration: "An enormous distraction … massive overkill. The problem with SOX is that it asks for perfect information – but what's the cost of perfect information versus sufficient information?" characterizes one view. To comply with Section 404, many companies are increasing staff in control functions, hiring external consultants, and calling on auditors to testify to their efforts. Estimates of the compliance costs range from $5 BN to $35 BN (Exhibit 4).

Exhibit 4: Costly compliance

2004 estimated SOX compliance costs economy-wide



	Korn Ferry	Big 4 Accounting Firms (extrapolated)	Corporate Executive Board (extrapolated)	Financial Executives International (extrapolated)	AEA
Average Sarbox costs/company ($MM)	$5	$7.8	$9	$4.1	Unknown
Sample #	Unknown	90 Fortune 1,000 $8 BN avg rev	37 Fortune 500	217 $0.1-5 BN rev	Unknown

Sources: Europeans vocal in opposition to Sarbanes-Oxley, 11 January 2005 by Fran Howarth; WHAT IS THE SOX FORECAST FOR CPA FIRMS? 1 June 2005 Accounting Office Management & Administration Report; CEB Finance Practice May 2005, 2005 Sarbanes Oxley Section 404 Audit Fee Benchmarks; FEI Special Survey on Sarbanes Oxley Section 404 Implementation, Financial Executives International March 2005; Sarbanes-Oxley Section 404, American Electronics Association, February 2005; Compustat; Mercer Analysis.

On top of the cash costs of compliance, there are indirect costs such as the opportunity costs of dedicating staff to compliance who could be engaged in value-creating activity elsewhere. Moreover, in more dynamic industries, increased regulatory or Board scrutiny may be limiting overall risk tolerance and slowing decision making.

The strains of SOX implementation may be coming to an end. One CFO said: "Even the SEC would say things went too far last year. It's a pendulum issue – and last year in particular it went way off the map. People were covering themselves all over the place, because [auditors] didn't understand the vagueness of the rule." A similar pattern may arise in Canada, the EU, and the UK as implementation efforts ramp up and are then adjusted to compensate for any initial overreaction.

However, regulatory uncertainties and pressures remain. As another CFO said, "One never knows if revisionists at the SEC will reinterpret historical accounting policies and decisions, and hold you accountable."

The Board has become more involved in reporting and business review

The CFOs were almost unanimous in observing that the nature of their relationships with their Boards had changed. Boards are seen to be fulfilling their responsibilities with renewed vigor and unprecedented thoroughness. They are also reminding CFOs of their fiduciary responsibilities, ensuring that the CFO works (in part) directly for the Board.

CFOs also noted changes in the caliber of Board members and the greater focus on relevant backgrounds in the Board-recruiting process. An independent, candid Board of outsiders can ask tough questions of management, helping to improve overall performance. On the other hand, new members generally need time to learn their roles. New Board members may also bring different appetites for risk, which may not fit that of the overall business; they may require more communication, education, and patience to become integrated.

Audit Committee meetings have increased in frequency, typically meeting in person every time the Board meets as well as holding conference calls in advance of earnings announcements. Many CFOs said that meetings have become more formal and adhere more closely to the agenda, and their duration and intensity have increased. Meetings that previously lasted one hour now last four; meetings that previously presented top-line numbers now focus on accounting technicalities.

Several companies reported that the scope of the Audit Committee has grown broad enough to require new subcommittees that address specific responsibilities, such as financial structure or macro-governance issues. Subcommittees may ensure that the company maintains its focus on key issues, but also create an additional set of meetings for which the CFO must prepare.

Auditor relationships are less advisory and collegial, but more expensive

The recent increase in regulatory scrutiny has also affected audit firms and their client relationships. Some 85% of corporate Audit Committee members surveyed by PricewaterhouseCoopers in 2004 agreed that they expected more of external auditors; nearly half acknowledged that they placed "great importance" on the value of external auditors in the area of compliance.

Auditors, meanwhile, have become increasingly conservative, mindful of the fate of Arthur Andersen and the potential consequences of overstepping the perceived boundaries of their roles by offering advice and opinion. Ironically, many CFOs complain that auditors are now exceeding their boundaries in a different direction – eradication of immaterial discrepancies.

Auditors have also focused more on the Audit Committee, not the CFO, as their primary client. Most of the CFOs with whom we spoke said that their relationships with their auditors had changed dramatically: Interaction has become increasingly formal, process oriented, and at times confrontational, with auditors intolerant of even negligible items and going directly to the Audit Committee with any perceived discrepancy. One CFO characterised this aspect of his job as being primarily about limiting the damage, disruption, and havoc wrought by his company's auditors.

The formalization of audit relationships has left CFOs feeling that they have lost a collaborative advisor on business and reporting decisions. Some CFOs at midsize companies said their access to audit firm partners has been reduced, and many topics have effectively been placed off limits or could be discussed only with the auditors' head offices (in the US) or technical departments (in the UK).

Today, "the auditors win," as several CFOs put it. "We used to close the books with statements of unreconciled differences, but now they don't exist. The managing partner has no autonomy; every little thing goes through head office." Some CFOs described retaining a second audit firm in order to have someone with whom they can discuss accounting issues.

This reduced access typically accompanies a larger engagement bill. While many in the US believe the bill for audit services has peaked, few expect it to revert to pre-SOX levels. Even if costs are reduced, however, the client shift from CFO to Audit Committee is likely here to stay.

Business complexity

The past decade has seen a remarkable shift in the strategic environment. Many of the CFOs described how business models have become increasingly short lived and fluid; strategic risks arise more quickly and dramatically; and corporate diversification and global expansion bring new and unfamiliar risks to the table. Faster business evolution creates new demands on the Finance function.

The dynamic is most evident for companies that rely heavily on technology, as intellectual property protection lapses, technologies evolve, and processes become obsolete. The music industry, for example, has struggled with the shift from centralized distribution of physical media to distributed digital transmission over the Internet that may skirt or violate traditional copyright regimes.

Increased globalization has brought new threats and opportunities as well. Global opportunities and risks are expected to surge over the coming decade, fueled by more than $440 BN of foreign direct investment in China and India alone.[4] CFOs are being asked to help identify and resolve the implications of complex licensing arrangements, joint ventures, cross-border M&A, international divisions, offshore ventures, and partial outsourcing. To accomplish these tasks, CFOs must become well versed in cross-border reporting, risk-based decision making, and managing the complexities of a global organization when conducting financial reporting and controls.

This global economy presents a higher level of strategic risk for most firms. The CFO must address new risks ranging from supply chain vulnerability to the legal and regulatory risks of operating in emerging markets, to the failure of intellectual property protections, to the migration of talent to foreign employers.

Footnote

4 Mercer Globalization Study, 2005

For example, one CFO highlighted the challenge of rebalancing his supply chain. Previously based in the US, Mexico, and Europe, its 'center of gravity' had moved to Asia. His advisory role included taking the lead on anticipating the implications of this shift for supply diversity and security.

Other examples relate to Finance's role in setting and measuring progress against new, more complex growth objectives. One CFO described a shift from divisional to cross-division and cross-geography growth objectives in order to support corporate targets. The requirements for Finance included new performance management metrics to track ventures and set management objectives, while complying with multi-jurisdictional reporting requirements.

Another CFO described the implications of his company's move from being a "US producer with global distribution" to a "global company with joint distribution agreements in multiple markets". This CFO was asked to model and advise on new revenue-sharing constructs, revised operating expense models, and the capital tradeoffs of various structural options.

4. Effects on the CFO

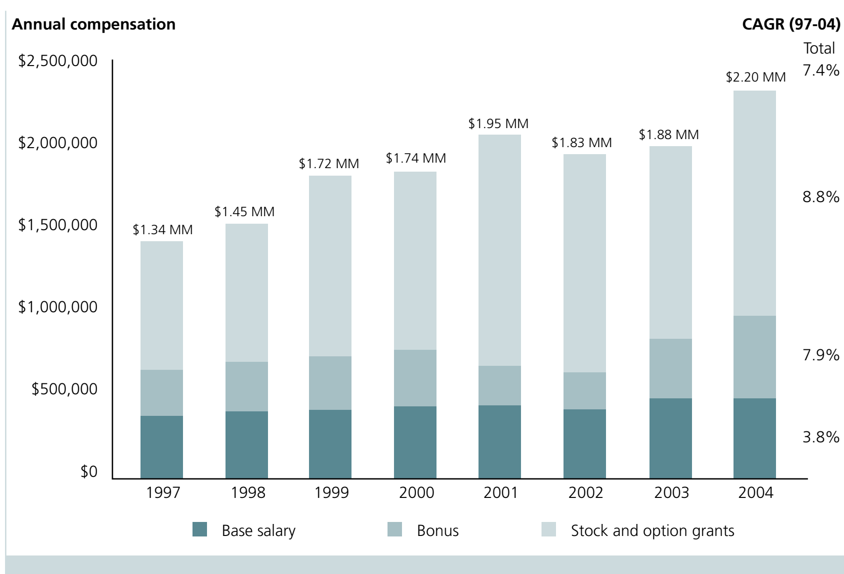
These changes in market dynamics, stakeholder relationships, and business complexity inevitably affect the people charged with managing them. CFOs are becoming more highly paid for their newly demanding role, which is also increasingly accepted as good preparation for other senior positions. While some CFOs find the challenge invigorating, others find the demands gruelling and the increased focus on controls unfulfilling. As a result, in some markets it may be difficult to find appropriately skilled and motivated candidates for CFO positions.

A new, and better paid, breed of CFO is emerging

While the demands made of the CFO have increased, so have the rewards. Total compensation has grown at a compound annual rate of 7.4% in the US since 1997, with more of that increase coming from variable components such as bonus and stock grants than from salaries. As shown in Exhibit 5, average annual compensation for the Mercer 350[5] CFOs surpassed $2 MM for the first time in 2004, rebounding from equity market-based reductions in 2002-2003. The trend was similar in the UK.

Exhibit 5: Compensation increasing

US CFO compensation



Source: Mercer 350 CFO Compensation Survey.

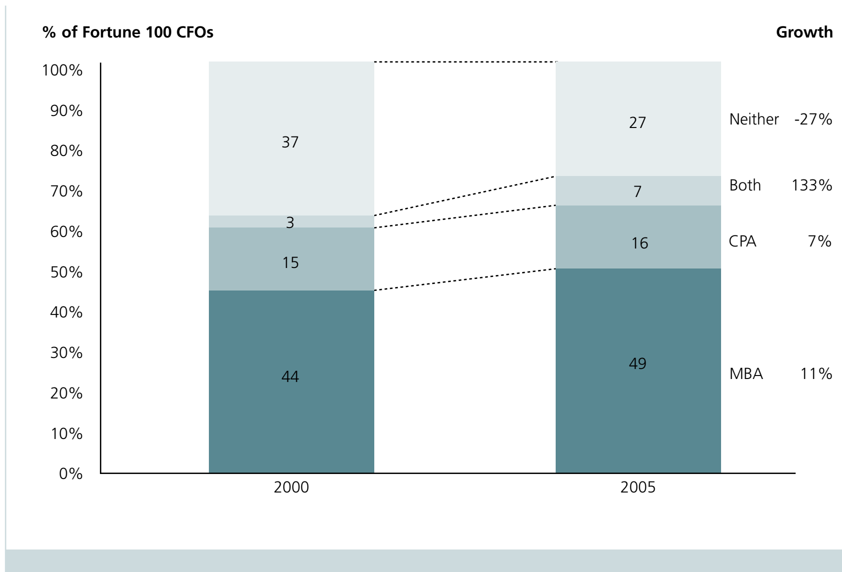
Footnote

5 The Mercer 350 is a Mercer Human Resource Consulting sample of 350 major industrial and service companies with over $1 BN in revenue who issued a proxy statement before early April of the following year.

Along with the rise in compensation, we found evidence of a change in the backgrounds of CFOs at leading US firms. Analysis by Russell Reynolds Associates indicates that a growing share of CFOs have an MBA, a CPA, or both (Exhibit 6). In the UK, many CEOs will not employ a CFO who does not have a formal accounting qualification.

Exhibit 6: Background check

US CFO backgrounds



Source: Russell Reynolds Associates CFO study of Fortune 100 companies

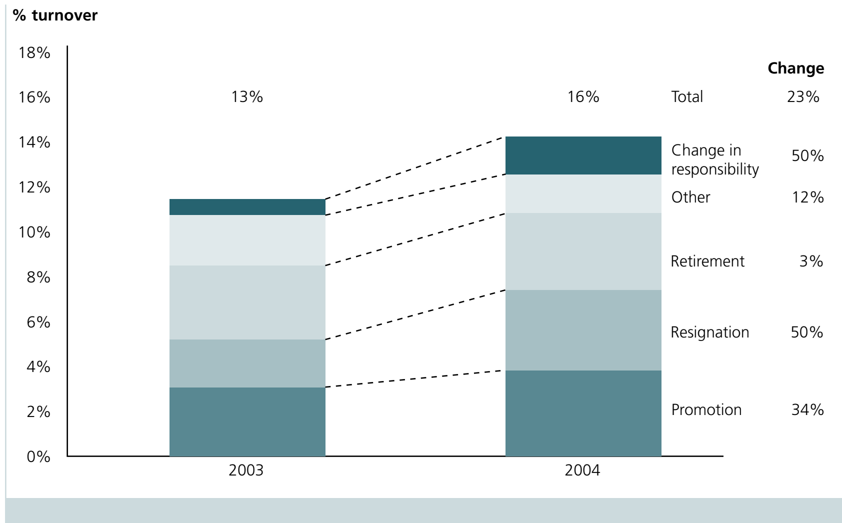
This study also found that more firms are hiring CFOs from outside, with the share of CFOs moving up via internal promotion declining from 82% in 2000 to 72% in 2005. These trends suggest a growing demand for 'professional CFOs' who have specialized functional expertise.

More CFOs are moving up or out

At the same time, the changing requirements for the CFO position have led to increased turnover. In the US, turnover increased between 2003 and 2004, as shown in Exhibit 7; CFOs in the UK acknowledged a similar trend there.

Exhibit 7: Up or out

CFO turnover



Source: Russell Reynolds Associates study of Fortune 500 companies, March 2005, total turnover and reasons

Senior leadership opportunities are becoming more accessible to successful CFOs. Almost a third of CFOs who left their positions in 2004 reported the move as a promotion to CEO, Chairman, or to a CFO role at a larger company or a new industry, with private equity proving an attractive choice. Others mentioned taking on multiple Board positions at an earlier age. The financial experience of the CFO seems increasingly useful in winning a CEO position, with the proportion of former CFOs who became US Fortune 100 CEOs increasing from 5% in 2000 to 14% in 2005.[6] There is a similar trend in the UK, although a significant number also move to the Chairman position.

While the prospects of career advancement may have brightened, the risk of burnout is also rising. Resignations have grown by 50% and many appear to have decided that the increased pressure and intense scrutiny is not appealing. A number of UK CFOs said: "I would not take another FTSE 100 CFO role." One commented, "If I were a younger Financial Director coming up through the ranks, the thought of managing a business' finances in the current governance environment would not be appealing." Media scrutiny is also a factor as the CFO's personal profile, compensation, and performance are more frequently fodder for press coverage.

The personal strain is evident, although many CFOs expressed stoicism when asked about their work-life balance. One CFO insisted that "everything is fine," but then mentioned working 14-hour weekdays, four hours on the weekend, and vacation with the Blackberry always on. Another summed up the dilemma: "Hair, golf, tennis – all gone. Time management is a challenge." Many noted that enjoyable business activities, such as meeting peers or participating in industry working groups, have fallen by the wayside.

Footnote

6 Russell Reynolds Associates CFO research

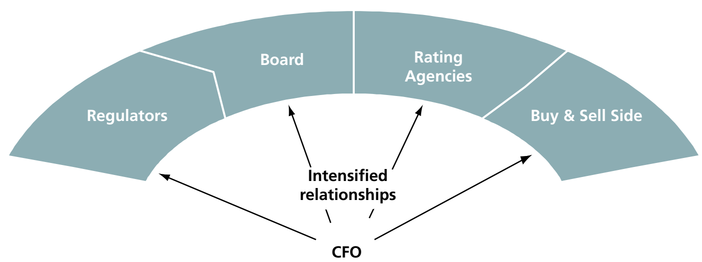
Some expressed concern that the pipeline of future CFOs is drying up, with candidates deterred by the professional and personal demands of the job. As one CFO told us: "Young guns used to say 'I want your job.' Now they say 'I don't want to do that. You have to travel too much; you have to sign all these documents. Too much stress. Life is too short.' " Russell Reynolds Associates' experience in placing financial executives suggests that the changing CFO job profile may be affecting the supply of interested, capable candidates. More potential candidates are expressing concern about the attractiveness and pressures of the role, or are averse to moving to companies in unknown business areas with unclear risks and liabilities.

The expanded CFO role also requires background and skills ranging from accounting to business partnership. It is not clear whether there is a sufficient pool of qualified and experienced prospective CFOs in every market. Where suitable candidates may be in short supply, relative priorities need to be clarified. For example, UK participants described financial control and accounting skills as critical, to ensure credibility when dealing with governance issues; competence in business support could be 'picked up' along the way.

CFO roles are becoming broader and more complex

Growing financial market sophistication, including increased use of derivatives and hedging, global capital sourcing, and market timing, have made mastering even 'the basics' more complicated. As a result, the roles of the CFO and the Finance function have become increasingly complex, as illustrated in Exhibit 8.

Exhibit 8: Changing pressures and responsibilities



	Financial Reporting and Control	Treasury	Investor Relations	Audit	Planning and Development	ERM?	IT?	Procurement?
						Added in last 5-10 years?		
Across the board deepening	▪ Increased criticality of controls and tax ▪ Decision support	▪ Globalization ▪ Balance sheet strength ▪ Risks ▪ Financial ▪ Hazard	▪ Regulation ▪ 'No spin' ▪ Analysis ▪ Transparency	▪ Internal ▪ Sometimes within Treasury	▪ Links to Capital Plan, P/E ▪ Line support	▪ Integrated ▪ Brand/ Reputation ▪ Scenarios	▪ Costs ▪ IT Sourcing ▪ Off-shoring ▪ Value	▪ Sourcing

The CFOs with whom we spoke were divided in their views on the degree of compatibility between their dual responsibilities of enforcing compliance and providing strategic business support. Some believe that there are synergies between these two mandates, with business processes drawing strength from compliance efforts. Others, however, said these priorities were conflicting rather than complementary.

In practice, compliance generally has the upper hand. Any CFO's first obligation is to get the basics right, including systems, controls, and reporting, as well as governance; only then can the CFO contribute to the commercial and strategic agenda. Two perspectives reinforce this; "When push comes to shove, you staff compliance first, in terms of both budget and headcount," and, "All Finance employees focused on SOX during the first year it was in force. There wasn't a lot of business partnership happening." A recent industry survey appears to back up this viewpoint; while CFOs said they would like to allocate 55% of their time to strategic support, only 46% of time was actually spent on such activities.[7]

Whatever the long-term balance between these responsibilities, the role of Finance has increased dramatically in most large corporations. This is evident in the hit that companies may take to their market capitalization if the CFO leaves. The essential disciplines of finance and their effective practice are critical to governance, which in turn plays a major role in valuations.

Capable, creative CFOs are central to corporate success, and the psychic compensation that goes with the role must balance the demands and the workload. In the next section, we will examine some of the approaches that CFOs can take to manage these challenges.

Footnote

7 CFO Executive Board, Working Council for Chief Financial Officers, Spring 2004

5. Pragmatic solutions

The CFOs with whom we spoke discussed a number of common themes and approaches that they found helpful in forging ahead. Their approaches range from 'hard' solutions, such as hiring more staff and building decision-support tools, to 'softer' tactics, including relationship management and the promotion of shared cultural values.

Focusing on stakeholder communications and relationships

Many CFOs indicated that their first priority was to rebuild the company's relationships with the Board, Audit Committees, and other key stakeholders. Boards, put on the hook by regulators and under pressure to protect shareholder interests, are taking an acute interest in their companies' financial workings. CFOs are striving to win Boards' confidence by improving their awareness of reporting 'unknowns'; they are also trying to build productive relationships with auditors.

Actively communicating with the Board and Audit Committees

CFOs have responded to increased scrutiny from the Board by more actively educating Audit Committee members on the financial data and business dynamics. Many described conducting informal one-on-one meetings outside formal sessions, as well as training on specific topics. A few CFOs noted that their Boards had become concerned about any but the most open of discussions, operating on the basis of "say it to one, say it to all." In these cases, the CFO had to spend additional time managing larger, more formal meetings. In general, however, there was a close relationship outside of formal sessions between the CFO and the head of the Audit Committee.

Some CFOs are spending significant time on tailoring communications for Board-level audiences. Rather than sending reams of data or forwarding all internal documents, they sift and present information to ensure that the Board is comfortable. One CFO described her need to intercede on behalf of the Board to ensure that reports from the auditor are clear rather than confusing. Other CFOs are increasingly bringing specialists or experts with them to Board meetings, for two reasons: first, to inspire the Board's confidence by providing access to credible and detailed first hand information; and, second, to allow subordinates to gain expertise in Board-level interaction.

Developing rigorous processes to ensure there are no surprises

No CFO wants to spring surprises on the Board or Audit Committee. Volatile markets and wary investors mean that few surprises are pleasant: Unexpected bad news can quickly sink a company's fortunes, while startling good news attracts suspicion. Typical comments were: "The Chairman of the Audit Committee deals with surprises very badly" and "You never want to have a restatement."

There are two ways to ensure that unexpected reporting issues don't emerge at the last minute. The first is to agree from the start on the parameters, metrics, and basic process of the Audit Committee's reviews. Successful CFOs provide the Audit Committee with a framework or an approach for how the year is going to unfold. For example, one CFO secured agreement on a dashboard of 30 risks and parameters that the Audit Committee should routinely consider. This demystified the review process and ensured that the necessary information flowed to the Committee members in a timely fashion.

Another, complementary approach is to develop robust internal procedures for raising potentially problematic issues early on. One CFO decreed that all issues would have to be raised and logged six weeks prior to the quarterly announcement in an 'Audit Book' – failing which, "You won't have the same conversation with me twice." The same CFO also talks to the external auditors before any Audit Committee meetings to ensure that their communications do not raise unforeseen issues.

Selecting the right audit partner

As noted earlier, auditors increasingly view the Audit Committee as their de facto client, and this has sometimes distanced them from the CFOs who engage them and pay their bills. In response, a number of CFOs put the audit relationship out to competitive bid every few years; this helps to maintain adequate attention and to reinvigorate the relationship with the auditor on terms most relevant to the firm's requirements. Others are more reluctant to part with the institutional knowledge of their auditor firm, but nonetheless recognize the value of reaffirming their expectations when necessary.

At a minimum, re-evaluating auditor relationships creates the opportunity to renegotiate the terms of engagement, as well as to bring in fresh eyes on the business. Leading CFOs recommended that relationship factors should constitute a point of negotiation when renewing auditing contracts. For example, one CFO made a point of negotiating for increased on-site partner presence when switching audit firms.

Demonstrating leadership in Finance

Because CFOs want the Board to understand the workings of their companies, they must also ensure that their operations are working smoothly. The past few years have highlighted the importance of robust controls and financial management, a process that many CFOs believe requires root-and-branch dissemination of cultural values and management science.

Establishing and enforcing a culture of compliance

One CFO described his role as "adult supervision for the company," by encouraging the organization as a whole to act responsibly. Many CFOs articulated a responsibility to disseminate the norms and ethics of compliance to all employees – "making all employees responsible for the numbers," as one put it. Another phrased it in terms of reporting structure: "All employees have invisible lines to me," meaning that responsibility for compliance and quality of reporting should permeate the entire organization. Another tells new senior hires, "If I do something wrong, you can put me in jail."

On a tactical level, one Canadian CFO implemented 'whistleblower software' which provides a forum for employees with compliance concerns to raise them anonymously. The CFO told staff that everything reported would be investigated, with the outcome being reported to the Audit Committee. Other CFOs changed employee performance management systems to take account of compliance; all employees might be measured and rated on how well they fulfill regulatory responsibilities. A UK CFO implemented a bonus system for Finance staff showing strong functional performance in implementing IFRS, thus emphasising compliance over business performance.

Finally, another area discussed by some CFOs was their increasing role in formalizing business conduct standards and responsibilities globally. Some CFOs not only are involved in establishing standards and aligning global business practices, but also are working with Human Resources and Legal to promote corporate compliance and ethics, including overseeing the design of training and ongoing monitoring.

Building a strong, healthy partnership with the CEO

The CFO's best opportunity to make an impact on the organization comes from a close collaboration with the CEO while also maintaining a degree of independence. "The CFO cannot succeed without the confidence of the CEO," said one CFO, who emphasized shared values and common support for a compliance culture.

Others described an even more collegial partnership model. As one CFO put it: "I couldn't do this job if the CEO and I couldn't finish each others' sentences." Another suggested that the easiest way to develop this relationship was to "grow up" through the organization together, building on shared experiences and providing deep insight into the business.

As an interesting side note, different perspectives are emerging on the nature of a fruitful relationship between the CEO and CFO. Although CEOs tend to stress compatibility, Board members tend to seek someone who will be inquisitive and ask provocative questions. One Board member, previously a CFO of a large public company, cited his preference for "healthy give-and-take" and increased independence of the CFO. Others noted that it is critical for the CEO to understand the CFO's fiduciary duty to the Board, thus preserving clarity about the CFO's role and responsibilities.

CFOs themselves pointed out how they can counterbalance the strengths and weaknesses of their CEO. Said one, "My CEO knows that I am going to pressure test every decision. I am going to raise the tough issues – How realistic are the projections? What are the risks? Is it really necessary? etc. He looks to me for that. So, by the way, do the markets. If the CEO is the cheerleader for the company, then the CFO represents discipline."

Another CFO noted that while the CFO is often looked to for conservatism, there are times when he has to push the CEO. "Sometimes [my CEO] has a hard time with tough decisions. Even though there's risk involved in taking the decision, I push him because I think there may be greater risk in deferring or avoiding it."

Driving management science and better decision making

The CFO is also being called upon to provide leadership in business support. Finance can play a strong role here by ensuring that decision makers have the appropriate data and analytical tools.

The CFO of a consumer products company described Finance's role as being the dissemination of tools from the center, the coordination of cross-operating unit product lines, and the analysis of performance across business units. Another noted Finance's role in creating the common unit of measurement needed to choose among the risk-return profiles of such disparate investments as acquisitions, joint ventures, and licensing arrangements. This may include revisiting the relationship between head office and divisional Finance, in order to settle on common standards for return on investment. More generally, it may involve training the businesses in building appropriate decision support tools to a common standard.

Another CFO described the increased involvement of Finance in 'owning' decision support tools, including loyalty and pricing analytics, and in running them for the business. As Finance's role at some companies increases in such analytical support areas, Finance should partner closely with other support functions, such as Marketing and with business lines. One CFO brought his strategic and analytical business support role to the forefront, going so far as to say that his function's role is to "provide a constant, fact-based flow of profit ideas – both revenue enhancing and cost cutting – test them, and turn them into corporate initiatives."

Building a high-performance Finance organization

To manage their many challenges, CFOs must build their Finance teams into multifaceted organizations whose skills provide the necessary leverage.

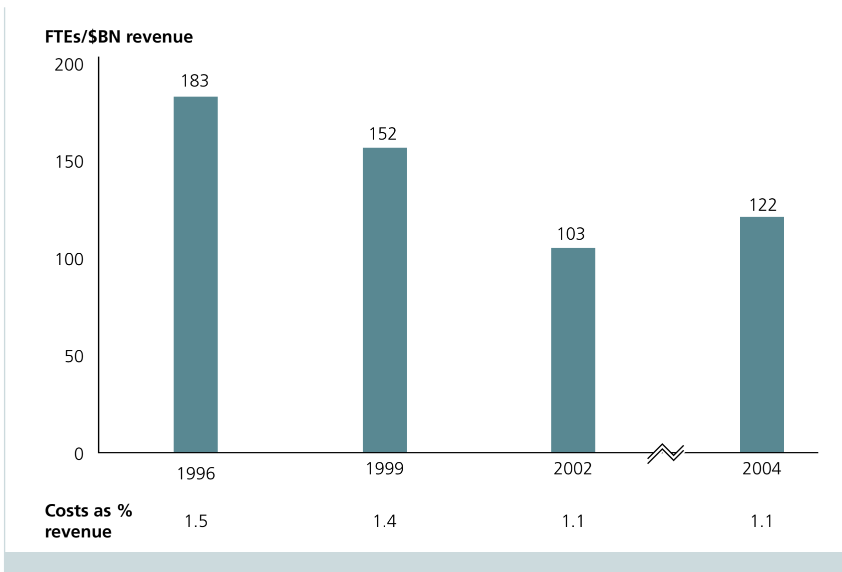
Rebuilding and rebalancing the Finance function, especially the Controller

Finance was seen as a prime location for cost cutting over much of the past two decades, but the changed business climate stopped that trend in some companies. As shown in Exhibit 9, the decline in Finance headcount reversed in 2004, with companies on average hiring employees, although they did not spend more on Finance as a percentage of revenues.

As one CFO commented, "This is the first time in my career that I have seen Finance being beefed up." Hiring additional CPAs, as well as certain functional experts, was a common thread, as was the removal of staff with little formal training in accountancy. A CFO from a technology company noted: "We went down with the bubble and have been building back up with a different mix, oriented towards SEC accountants, control-oriented people."

Exhibit 9: Building up

Finance function headcount



Source: Hackett Group

While the increase in Finance support may have been triggered by SOX and associated pressures, the trend may persist because of the CFO's expanded responsibilities. Without the appropriate staff, a CFO will not be able to succeed on various fronts, especially when it comes to key tasks such as financial control and investor relations.

Note that while some CFOs described a recent increase in headcount, others maintained a lean internal organization throughout SOX implementation by hiring temporary outside resources. These CFOs focused on making sure that key support functions are top-notch. As one CFO said: "The only reason I can spend 70% of my time on strategy is my excellent team; they are very productive." Another CFO said she relied heavily on senior staff: "I have a top-heavy staff that is well compensated and well titled and happy."

Foremost in the key senior positions is a strong Controller, and often Deputy Controller, with robust command and control of reporting. These roles now have much greater visibility with the Board. Many CFOs rely heavily on their Controllers for compliance and reporting issues, freeing them up to concentrate on strategic business topics. One CFO went as far as to say: "My Controller, on a matter of accounting, can overrule me." Another CFO said unequivocally, "There are some basic rules without which nothing else falls into place: Beef up Controlling . . . while dropping IT, HR, or other new functions. Influence comes from the credibility of the core Finance functions, not the size of the empire."

Hiring, retaining and developing talent

As demand for some of these roles has gone up, so have salaries and overall compensation. Some CFOs, particularly in companies that have historically experienced relatively high growth and rapid stock appreciation, expressed growing concern about their ability to keep people over the long term if their compensation drivers slowed down.

Building a strong bench requires not just aggressive hiring programs, but also solid development programs for the people hired. As one CFO said: "A good 25% of my time is spent on people development – making sure we have a real development process; giving them experience, global postings, and outside training, letting them get on councils, and so on. I think about 25% of recruiting should be outside, and 75% should be from within, to build bench strength."

Ensuring attractive career paths through a strong development program of rotations, training, and coaching helps build strength within Finance and throughout the organization. Of course, building this pool of talent has direct and indirect costs, including the risk that expensively groomed talent will be poached by other units or firms. However, one CFO noted that the costs and risks of personnel development are a "fundamental cost of doing business," and that a strong development process is critical to his success.

Embedding Finance talent throughout the organization

Most CFOs said that dispersing Finance talent into the operating or line units has several purposes. It brings Finance closer to the business, whether to ensure control or to improve understanding business objectives. It also helps the Finance function to build compliance into business unit reporting, to develop relationships with business unit staff, and to develop Finance staff and their understanding of the business's operations.

Numerous successful organizational and reporting patterns were described: Some were direct, others indirect. One company described its placement of people with Finance backgrounds into 'strategy and analysis' roles within the business units, with a clear matrix reporting relationship back to Finance. Success in these roles requires being a "constructive activist": These individuals are expected to provide a supervisory, control-oriented influence in the business operation, while also pushing the business units by asking tough, strategically relevant questions.

Many companies employ rotation strategies to develop the right mix of finance and business skills in their talent pool. Some rotate Finance people into general management or operations (and vice versa), while others tend to keep Finance people within Finance roles but rotate them between centralized functions (such as Treasury or Tax) and divisional financial support or controls.

Redesigning work to focus energies on higher-return activities

CFOs were keen to make sure that the right people were focused on doing the right things – work that delivers the most value to the organization. In some cases, rethinking the Finance function's scope, and improving its internal cost position, were prerequisites to funding some of the hiring and talent management involved in improving skills.

CFOs approach this objective in various ways, ranging from process redesign to centralization to outsourcing to automation. One systematically reviewed each Finance process to clarify its purpose and to rid the organization of wasteful activity. Another expressed thanks that his company "had the stomach" to implement an enterprise resource planning system during the downturn, without which SOX compliance would have been more difficult. Still others are exploring the centralization and off-shoring of transaction-based activities that don't add value. For example, one CFO moved all of his global accounts payable, receivables, expense reimbursement, and associated activities to a centralized location in Southeast Asia. He believed that his company's scale made this strategy cheaper than paying a contractor's margin to outsource the work.

Finally, some CFOs noted that it is important to identify and communicate to the rest of the organization how Finance adds value. For example, the CFO can engineer the balance sheet to optimize capital structure, manage accounts receivables or payables to increase working capital, and seek to minimize the company's tax bill. This value must be measured if it is to be appreciated. One CFO noted that 15% of his company's earnings per share came from a reduction in tax rate and a balance sheet restructuring that reduced interest costs. Other potential metrics might include avoidance of currency losses, the attainment of lower group tax rates than peers, or fulfillment of targets for acceptable levels of credit loss.

Developing systematic approaches to risk management

CFOs see a need for a more comprehensive, integrated approach in managing risk.

Improving the understanding of and preparation for business risk

Regulation has encouraged companies to tighten controls and risk management, yet there remain potential surprises arising from strategic, financial, operational, and hazard risks. The savvy CFO will therefore continue to explore other ways to anticipate and mitigate risks.

CFOs with whom we met generally suggested that their high-level interest in enterprise risk management (ERM) has outpaced its current level of implementation. The full spectrum of risks may be reviewed today, often thoroughly, but on a piecemeal rather than an integrated basis. The checklist approach taken by some traditional ERM frameworks is not particularly useful to most CFOs, but they have not yet had the opportunity to implement more integrated approaches.

Large strategic risks are moving closer to the foreground of CFO thinking, referring to the array of external events and trends that can devastate a company's growth trajectory and shareholder value. This trend can be seen in sectors as diverse as energy, telecommunications, technology, pharmaceuticals, and retailing. It includes risks that attack current earnings via sudden price or share shifts, as wells as risks that change the value of capital-intensive new product or R&D pipelines, or of current cash flows.

As regulation-driven compliance implementation winds down, it will become possible to devote more attention to some of the 'unmeasured and unknowns' in the risk spectrum. These developments may flow from an existing ERM framework, or from a broader and more integrated risk framework. However, all agree that the development of better risk-return decision-making is on the horizon.

6. Centrality amidst complexity

The role of the CFO, while always demanding, has become increasingly complex in recent years and more nuanced than recent characterizations might suggest. Some of this complexity may dissipate as the initial rush to implement regulatory solutions slackens and resources are freed up for other, potentially more value-creating activities. In time, and with work, investor trust and suspicion may in due course return to historically normal levels.

Some complexity is likely to persist, however. One component of greater market volatility, for example, appears to be an intrinsic increase in the velocity of money, aided by technology, globalization, and professional investment. Strategic risk, too, seems unlikely to wane, rooted as it is in long-term macro-economic and geopolitical changes. Competitive pressures will continue to drive calls for the CFO to lend his or her expertise to the challenge of value creation.

The role of the CFO across these issues is fundamentally more central. In turn, that centrality provides unprecedented opportunities to influence and direct the course of the business. While some CFOs may opt out, others will seize the leadership platform this centrality presents.

MERCER

Mercer's Strategic Finance Practice works with CFOs, CEOs, and Board Audit Committees to improve the design, operational effectiveness, and strategic impact of Finance and related functions. We help clients to:

- Build high-performing Finance organizations and restructure internal and stakeholder relationships to improve effectiveness
- Help the traditional Finance functions absorb new finance disciplines and tools, including enterprise value and risk, management science analytics, and balance sheet management

The Strategic Finance Practice draws on specialist practices throughout the Mercer companies, which consist of Mercer Oliver Wyman, Mercer Management Consulting, Mercer Human Resource Consulting, Mercer Delta Organizational Consulting, Kroll, National Economic Research Associates, and Lippincott Mercer.

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