WHITE PAPER

FundingProfiles

# Translating Finance to Strategy

How FP&A Can Win Executive Friends, Influence Corporate Strategy, and Improve Shareholder Returns 40% By Doing What They Do Anyway

# Introduction

Most large enterprises fail to establish an effective link between their corporate strategy and their financial execution. One prominent research firm found that this problem is rampant in large enterprises, resulting in a 40% loss in shareholder return over time. Using an approach called Funding Profiles can add strategic perspective to common FP&A activities and help mitigate this problem.

# Strategic Emphasis

Many companies are great at setting strategies. These companies recognize that strategy is crucial to their survival and their board's choices usually reflect that understanding.

Many top business schools and consulting firms cultivate strategic thinking. Top corporate executives, who often attended these schools and did stints at these consulting firms, are highly sought after for their prowess in formulating strategy. Most large companies have entire departments with a dedicated focus on strategy. These departments are usually staffed with individuals who attended these same business schools and worked in these same consulting organizations.

Creating strategy is usually more of an art than a science. Inputs to the strategic formulation are information-based. Some points of information are raw data points such as market definitions, TAM, forecasts, and business drivers. Some points of information are more subjective, such as competitor trends, M&A activity, and technology innovations. Everyone has a slightly different strategy formulation process and cadence, but companies use a "funnel" metaphor. In this metaphor, the beginning of the process starts with large scale strategic considerations, and the process narrows down as various strategies are considered until a strategy is formulated.

Communicating strategy is an art in and of itself. The outputs of this strategy formulation process are as important as the process itself. The strategy is communicated to and endorsed by various constituents in various ways – boards, corporate executives, managers, and employees. Most companies correctly place a high degree of importance on an effective communication of strategy.

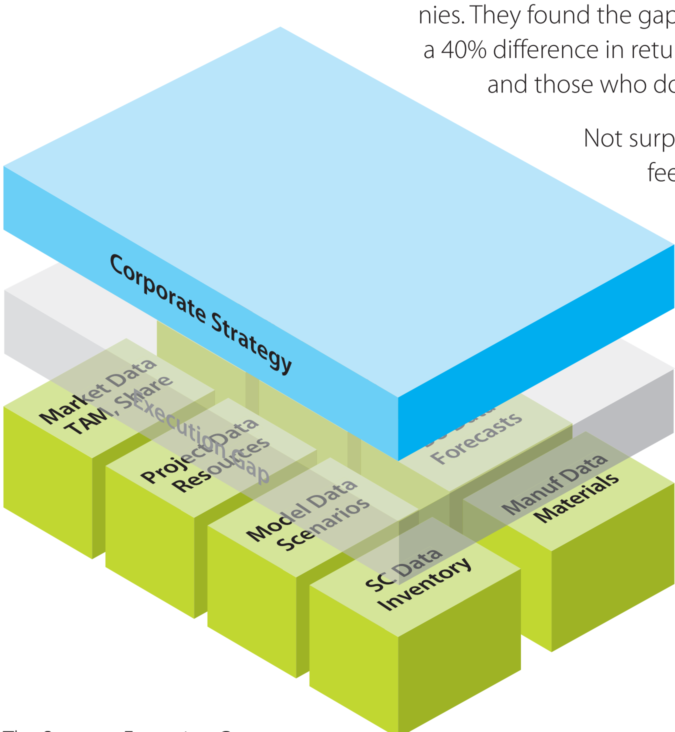
# The Strategy – Execution Gap

Unfortunately, most companies also mistake the articulation of corporate strategy for an ability to effectively execute that strategy. Equating the articulation of something to its execution does not make it so. The inability to execute a stated strategy has been called the "strategy-execution gap." This gap is well documented. It has been the subject of frequent studies. Last year, McKinsey Research published an extensive study of this gap, and even quantified the impact on public companies.

The name of that research study **"How to put your money where your strategy is"** is significant because it identifies the reason for the strategy – execution gap. According to the research, most companies allocate the same funds to the same business units year after year without regard to the evolution of their strategy. That same research piece studied the effect of the gap on large companies. They found the gap is the rule, not the exception. They also quantified the gap, and found that a 40% difference in return to shareholders exist between the few companies that address this gap and those who do not.

Not surprisingly, those persons "standing in the breach" – a company's employees, feel this pain acutely. Embracing (or Buying into) a strategy can be frustrating and demoralizing if a company does not create an environment conducive to carrying out that strategy. In fact, the better a company is at communicating strategy, the more frustrating it is for a team if their budget allocation does not reflect the corporate strategy because employees become more acutely aware of the problem.

Many companies have attempted to deal with this frustration through HR tactics designed to encourage employee alignment with corporate objectives. Without real departmental allocations which match those interlocks, these efforts are applying Band-Aid™ solutions – treating the symptom without addressing the underlying cause.




The Strategy-Execution Gap

# The Reason for the Strategy-Execution Gap

There is a clear cause which needs to be addressed. Departments in large organizations need to receive budget allocations which show a company is serious about accomplishing its strategic objectives – that they are truly willing to "put their money where their strategy is."

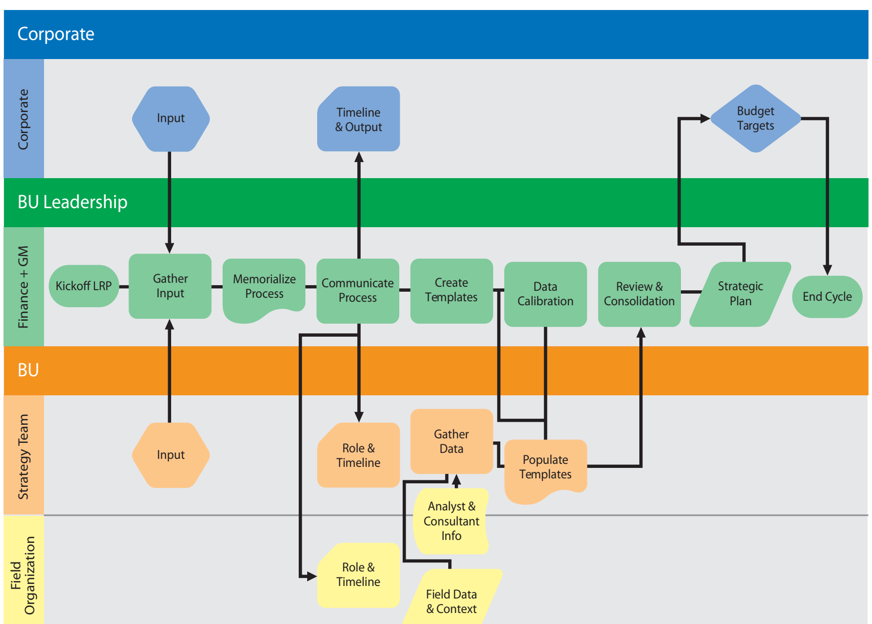
*In one large high tech company, the areas of strategic emphasis for the coming year were clearly identified by corporate management. A board packet was created by the CEO which identified the company's strategy. Badges were distributed to all employees with the corporate goals printed on them. A sophisticated system of cascading employee objectives linked corporate objectives to individual executive goals to manager goals to employee goals. In one encouraging step, long range planning scenarios were created which aligned annual budget allocation for the next year to these corporate goals. Ultimately, the budget allocations associated with these scenarios was rejected in favor of a much simpler allocation method – distributing budgets based on the previous year. The result was a crippling mass defection of some of the most qualified leaders and individual contributors.*

The root causes behind the inability to allocate budget according to strategy is easy to identify. Addressing it is not. Just like it is hard to turn a battleship, it is not easy to accomplish large budget reallocations in a big company environment. There are usually two important reasons. First, it is usually not easy to identify objective ways in which budgets would be allocated differently. Second, even if it were easy to identify, the political will to impose the reallocations often doesn't exist within large corporate environments, i.e., inertia rules!

# Budgets Usually Reflect Tactics, Not Strategy

This happens because the allocation of budgets in big companies can have a big impact. This process takes different forms in different companies. In some companies, budget administration annual budgets are created by executive decision makers and communicated to business leaders. In other companies, business leaders create budget requests and associated forecasts which serve as important context in how budgets are set.

In most companies, regardless of which approach is used, budget allocations rarely change dramatically from one year to the next. Whether there is greater or lesser "affordability" from the previous year, the most common initial approach to a surplus or deficit is an equal spread among various business leaders.




A typical long range planning process

As a next step, companies often make minor adjustments in their allocation. In a typical situation, if a company's leadership is feeling especially "strategic," they may then reduce the allocation for some part of the business and increase the allocation for others. This minor reallocation is usually done based on instinct – business leaders usually instinctively know which parts of the business hold more promise and which ones are likely to under perform. Because these minor tweaks typically have a large impact on the business leaders' organizations, they tend to be small.

Larger budget shifts which are capable of keeping pace with a company's evolving strategy are rare. The strategy-execution gap develops for this reason. Most companies make their largest budget evolutions in hard times when they are forced to make triage decisions. If they are able to successfully recover, the way that they allocate budgets almost always returns to the way it was before the crisis, because that is the only way a company knows how to budget normally.

There is a certain inertia at play here. Because companies have built structures that they perceive a need to support, sustaining these structures requires a roughly equivalent budget allocation. Making major budget reallocations without a very specific plan can have unintended consequences in this environment. This happens because organizational structures which support strategic initiatives can be eroded, ultimately diminishing a company's ability to execute against its strategy instead of supporting it. For this reason, it is rarely apparent HOW to go about major budget allocation shifts.

There is also a certain element of political resistance here. Especially in large companies, budgets tend to involve a certain amount of negotiations, so that budget allocations are typically influenced by a very broad executive audience. When it comes to sensitive budget discussions, the human self-preservation instinct usually kicks in. The squeaky wheel gets the greased for a reason. This collective instinct usually makes it difficult to execute major budget reallocations.

The fact is that it is difficult to identify proper budget reallocations, and even when a company can identify how to successfully reallocate, it generally lacks the political will to make the hard choices. It is little wonder that a gap develops between a company's aspirations and its ability to achieve them. Unfortunately, the scapegoat for this dilemma is often finance.

# Finance at the Nexus

Finance is usually at the point of intersection of the strategy/execution gap. This happens because finance is responsible for administering budgets as well as planning them. In most companies, finance coordinates a long range planning process designed to set budget for the next year. Finance also administers the budget throughout the year, recommending tweaks when necessary. At least on paper, this long range planning process is sometimes associated with a parallel process of strategic planning.

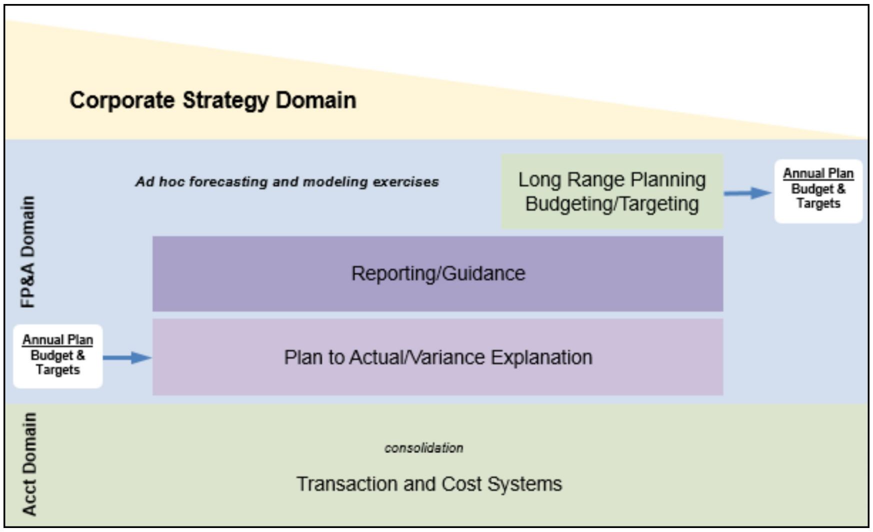
The implication, often rendered explicit, is that finance is the organization responsible for coordination of a company's resource allocation. Of course it is up to the lines of business to execute. However, as the link between the lines of business and the strategic heart of the business, finance serves as an important line of communication.

Finance is responsible for issuing plans, tracking performance, explaining variances, creating forecasts and guidance, and developing recommendations. These responsibilities are critical to a company's success – without these functions a company would function without any control point and would lose an important source of visibility. Still, because these activities are standard in finance organizations, they are often taken for granted. Even worse, they are often taken for granted and only recognized when a mistake is made in one of these areas.

Perhaps most impactful of all is the fact that most companies treat these activities as tactical and fail to capitalize on their strategic potential. The next two sections examine these activities in detail, and illustrates how finance organizations can make the same activities be perceived as strategic contributors and help companies close the strategy-execution gap.

# A Year in the Life of FP&A

There are common responsibilities which typically fall into the domain of FP&A in every company. This section lays out those responsibilities, and talks about them in the context of the larger role that they play in an organization. The section looks at finance activities, then planning activities, then analytical activities.




Common FP&A Responsibilities

Typical finance activities include **consolidation** and **reporting**.

The inputs for consolidation differ widely from company to company. Consolidation always involves some systems work – gathering data from various sources. Usually consolidation isn't conducted by one individual; different people on a team may be responsible for consolidating different financial components like bookings, revenue, opex, etc.

One of the key outputs for consolidation is reporting, which happens quarterly. Reporting is an output function, and usually involves meticulous formatting of data. In the most automated cases, these reporting output functions are pre-formatted and creating desired reports for compliance purposes occurs with a few mouse-clicks. Reporting is always numerical, and rarely may involve a few graphic components as well. Reporting generally involves a comparison of actual results to a stated plan. Often there is a set of internal management reporting requirements which significantly exceed external/SEC reporting requirements. Usually, the larger the company, the more complicated the management structure, and the more intricate the reporting.

Typical planning activities involve **budgeting** and **long range planning**.

Budgeting is where "the rubber meets the road." Most large companies have departments (or their equivalent) which administer budgets. These entities live within business units, regions, functions, or some combination of these. Usually, formulating and handing out budgets is the responsibility of corporate FP&A. These budgets often have targets or plans associated with them. These budgets and their targets are usually set annually in a long range planning process, and tweaked quarterly as results are processed.

Long range planning (or long term planning, or capital planning, or other terms) describes the process large companies use to create annual budgets. Most often this process is coordinated by finance. The process often requires detailed information from business owners. In these cases, it is finance's responsibility to make sure that the required information is collected and consolidated in a timely manner.

| Scenario Data | Section One "Base Case" Financial Information | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | | 2014 | | 2105 | |
| | $ | $ | Growth | $ | Growth | $ | Growth |
| **Revenue** | | | | | | | |
| Product Revenues | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Asia | | | | | | | |
| Europe | | | | | | | |
| North America | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Support Revenue | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Asia | | | | | | | |
| Europe | | | | | | | |
| North America | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Professional Services Revenue | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Asia | | | | | | | |
| Europe | | | | | | | |
| North America | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| **Total Revenue** | **$0** | $0 | **0** | **$0** | **0** | **$0** | **0** |
| **Asia** | | | | | | | |
| **Europe** | | | | | | | |
| **North America** | **$0** | **$0** | **0** | **$0** | **0** | **$0** | **0** |
| **Cost** | | | | | | | |
| Product Revenues | $0 | $0 | 0 | $0 | 0 | $0 | 0 |
| Asia | | | | | | | |
| Europe | | | | | | | |

Instructions | Guidance | Corporate Rollup | **Business Unit 1** | Business Unit 2 | Business Unit 3 | Business Unit 4

A typical long range planning template

Often using forecasts gathered during the long range planning process provides finance with a unique perspective on potential future results. It is this privileged insight that is usually called upon to provide analytic insights. Common analytic roles for FP&A include modeling, scenario creation, and guidance.

Modeling and scenario creation are usually ad hoc requests made by the CEO, CTO, CSO, or some other influential business executive. Often the requests are amorphous, such as a request to model the potential impact on the business if two competitors were to merge, or if a recession struck an emerging market. Other times, the requests are quite specific, such as modeling the impact of spending 10% less in sales and marketing for the next 18 months. In both cases, finance is the organization usually viewed as best suited to provide insight to these scenarios.

In public companies, finance is usually called upon to provide guidance to the executive team. Even when (as is increasingly common), a company does not provide specific guidance on its earnings call, remarks by management usually portend future results. As the group best positioned to understand business dynamics, finance is usually obligated to share insights with the executive management team in the form of expected guidance.

Unfortunately, the collective obsession with numerical output in all of the above roles usually limits the true strategic value of corporate FP&A. While this result is unintended, it is almost always the case. There are many barriers to be considered.

# Common Challenges to FP&A

Quite often, FP&A spends most of their time on the F&P portion of their job, and very little on the A. In fact, the time FP&A usually spends on the analysis is often counterproductive. Very smart people with excellent analytical potential spend too much time consolidating data and generating reports.

Often companies get carried away with data. These companies spend a lot of time thinking about how to quantify almost all aspects of their business. Everything from corporate goals to department culture can and have been translated into numerical values. Many companies use numerical scoring guides as a substitute for difficult qualitative discussions. Still others find that they ask for more data than they can possibly produce or sift through. In these cases, critical resources may be filling out forms or templates at the expense of their business productivity. Still other important analytical resources are spending most of their time accumulating and sorting data, and insufficient time actually analyzing the data for results. Ultimately, when data is accumulated and sorted, decision makers in these environments typically find themselves in an information overload situation – there simply are too many numbers for them to make a real business decision.

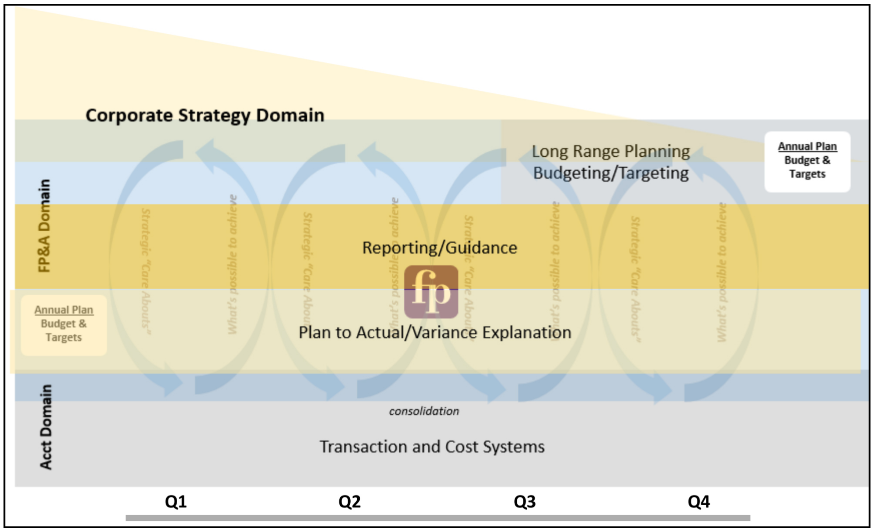
Other companies seem to be in the opposite situation. These companies put the proverbial cart before the horse when it comes to their planning processes. Rather than using FP&A to solicit input from business leaders, these companies miss a strategic opportunity by providing specific financial guidelines to the business leaders in order to expedite the planning process. Because these companies tend to "play it safe" by keeping business leaders on a tight leash, they rarely rebalance investments across business units. For this reason, these companies have portfolios that tend to be fairly static. Since most business leaders will choose to spend their budgets on "keep the lights on" type of activities, often these companies will have rather low "innovation" tendencies. The result is that these companies will often fall behind their competitors. This is especially problematic in very competitive marketplaces. These companies also foster a business climate which rewards those who do not take risks because they become complacent in their "business as usual" approach. In the long term, these types of companies will experience deteriorating business results for reasons that are usually difficult for FP&A to trace.

Both extremes described above are common. Most companies seems to have gravitated close to one extreme or the other. Both marginalize the potentially strategic impact of FP&A. There is another way for FP&A to impact strategy. This technique will usually make FP&A more popular in an organization while having a positive strategy effect. Best of all, this approach is additive – it saves FP&A time while in the process of making a positive strategy impact.

The approach is called Funding Profiles.

# Transforming FP&A

The goal of this approach is to harness the power of existing FP&A process described above. This approach can tighten the link between FP&A and corporate strategy, closing the strategy-execution gap which plagues most large companies.




Creating a Feedback Loop Between FP&A and Strategy

This approach helps FP&A contribute to an enterprise's strategy beyond just numbers. By integrating with existing business applications this approach continuously translates traditional financial metrics into the language of business strategy. Finance teams should express plans, targets, actuals, forecasts, or scenarios in strategic perspectives any business leader should appreciate.

Using this approach, finance teams can produce strategic presentations specifically tailored for various unique executive audiences, including: Board of Directors, CEO, CFO, SVP Strategy, Business Unit GM's, Region VP, Channel Executives, or Product Line Managers.

FP&A teams do what they would do anyway, but the Funding Profile approach can help transform these roles. For example, Reporting and Variance Explanation involves automating the explanation of the bridge between plan and actual using strategic terms.

This approach also makes it very easy to use Modeling and Scenario Evaluation to assess the strategic implications of scenarios under consideration. It also makes forecasts strategic by enabling users to visualize strategic implications of forecasts. Because of its continuous translation effect, the Funding Profiles approach helps align execution with strategy.

# Using the Funding Profiles Approach

The Funding Profile Approach is like a bidirectional translator between strategy and finance. Strategy organizations and other business constituents use their input to create Frameworks. Finance groups populate the Datasets. The combination of the two is strategy visualized.

This approach creates customized presentation support for any business constituent using data from plan, actual, forecast, scenarios, or long range plans. This same data is viewed different ways by different audiences. For example, a channel executive and a business unit general manager usually have very different sets of strategic concerns. Because of their different perspectives, they will look at the same data set differently. By applying custom-built strategic Frameworks to any set of data, a Funding Profile approach quickly and easily builds decision-ready analytic output.

When FP&A organizations embrace the Funding Profile approach, they inherently become more strategic in their approaches to reporting, variance explanation, guidance, and planning. McKinsey research quantified the impact of the strategy – execution gap. The Funding Profiles approach was created to help companies close this gap.

*A well-established software company had multiple product lines, multiple business units, and did business in multiple parts of the world. The complexity in their business led them to embrace the Funding Profiles approach. As Heidi Flaherty, Vice President of Finance and Investor Relations at Advent Software (NASD:ADVS) noted: "using the Funding Profiles methodology last year helped us gain actionable insight into our strategic plan and helped us bridge our long range plan with our operating budget."*

Embracing the Funding Profiles approach does not require FP&A to do anything differently than it currently does. Providing better support to business constituents by integrating the Funding Profiles methodology on top of existing FP&A processes helps in two important ways.

As diagram 4 above shows, the Funding Profiles approach creates a tight linkage between FP&A activities and strategy. While it is valuable for the FP&A team to translate their results into strategy in order to close the execution gap, FP&A also has a key role to play in the development of strategy itself.

Those of us most familiar with the strategy-execution gap tend to put the emphasis on making budgets reflect strategy more. While this is undoubtable true, and probably responsible for most of the problem, there is another explanation which deserves consideration and emphasis. The truth is, reallocating budgets according to strategy is hard for a reason – sometimes strategies are so far afield from what is actually possible to achieve, that budgets simply cannot be altered to reflect strategy without a complete restructuring of a company.

In order to make actionable budgets, a company must have an actionable strategy: enter a strategic role for finance. As strategy departments go through their annual exercises of strategic planning, it is incumbent on Finance, Planning and Analysis departments to create actionable scenarios for the next year which create "boundaries" for strategic consideration. Strategy has to be encouraged to think broadly about what is possible for a company to achieve. This type of visionary thinking is what drives successful companies to keep achieving extraordinary results. This type of visionary thinking is most effective when bounded by what is actually possible to achieve. To do otherwise risks broadening the strategy-execution gap, with negative consequences to shareholders and all other stakeholders.

# Calculating the ROI

McKinsey Research has already quantified the impact of the strategy-execution gap. Slight improvements in closing the gap resulted in the creation of enormous value for most companies. A strong business case can be made for any approach which helps a company execute its strategy. By linking existing FP&A process to strategic perspectives which will help all business constituents, FP&A teams can have it all. They can win the hearts and minds of the executives they support with richer and timelier analysis. They can effect better strategic decision making. They can free up time for resources to help in the actual analysis of business drivers. By using the Funding Profiles approach, FP&A can win executive friends, influence corporate strategy, and significantly improve shareholder returns - all without any change in the way they currently operate.

Funding Profiles
440 North Wolfe Road
Sunnyvale, CA 94085
fundingprofiles.com
(408) 498-5840