Guidelines to Help Finance Become a Partner With Operations

R. Steven Player

EXECUTIVE SUMMARY

- Top management often fails to view the finance department as a business partner. In many companies, the finance function is not even viewed as a candidate for partnering.
- Operating managers tend to consider financial managers as mere clerks who process the bills or as corporate cops who check on compliance.
- To change the way people in finance are viewed, they will have to change the tools they use.
- Finance professionals who can master tools such as predictive logic diagrams will be able to predict and produce a business partner role for themselves.

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People who work in finance are often not considered business partners. Their peers and top management seldom view financial types as strategic thinkers who have the insight needed to make a business more profitable.

But why is this the case? The answer lies in the tools finance has traditionally used to execute its job. Top managers form opinions such as these after many years of watching finance work. In many companies, the finance department still spends 80 percent of its time on transaction processing. With the vast majority of the effort spent processing entries and reconciling the books, precious little time is left for value-added analytical work.

Even those finance groups with dedicated staff focusing on value-added analysis often have meager impact. In most cases, business analysts are hampered in their ability to analyze results until the closing of the books has been completed. Analysis may occur well past the time operations identified and corrected the problem.

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CHALLENGES TO BUSINESS PARTNERING

Many finance organizations work diligently to speed their monthly closing processes. There are many benefits to a rapid close, including higher quality and lower cost. Many finance professionals also claim that faster closing provides operating managers with timely information. However, this is an illusion—a false hope.

To illustrate, assume I have a magic wand that can instantly decrease a company's monthly closing from three or more days to less than one day: in fact, even closing below Motorola's world-class best practice of three hours, all the way down to zero—an instantaneous close. This magic process will start printing a company's monthly financial statements at the stroke of midnight on the last day of the month—the ultimate in timeliness.

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With this immediate close, finance professionals could take those freshly printed financials directly to departmental or operating managers for review. However, would these operating managers be excited and welcome finance into their home during the night?

Well, maybe a midnight review of financials is not all that exciting. How about review at 8 A.M. the next morning? What could those operating managers do with this timely financial information? All they could do with it is the same thing they do with today's financial information—validate 100 decisions they have already made. Having it more timely does reduce the overlap from this month's decisions, but it does *not* help with those decisions already made. This traditional financial information has been of little value to operating managers; therefore, finance has not been viewed as a business partner.

Unfortunately, this is not the only problem with the tools used by finance. Changing the way finance is viewed requires changing the tools used.

A TIME-FRAME FOCUS

As a tool of finance, variance calculations follow accounting conventions, which pose the second source of problems. Accounting records are divided into time periods—months, quarters, or years. Variance explanations also follow this approach. Unfortunately, the time-frame focus of this accounting cycle has little relation to how operating managers view their normal operational cycle.

Changing the way finance is viewed requires changing the tools used.

Sales managers often review the weekly activity of their sales department. Retailers focus on weekends and holiday sales events. Plant managers depend on daily production reports. The natural flow of operations seldom matches the accounting month. Accountants often ask operational managers for variance explanations for the month (which often starts and stops in differing portions of the operational cycle). This interaction merely highlights that the cycles are not matched to the normal flow of operations.

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Operational managers who must stop their work to explain results to the accountants rarely see value in these discussions and analysis. Instead of adding value, finance detracts from value. As a result, finance is not viewed as a business partner.

AGGREGATION

Closely related to this problem of time-frame focus is the third problem of using variance analysis—whereby finance lumps all effects into a summary number. For example, the words used in most written variance explanations typically consist of one or two explanations of what happened followed by the phrase "and other items that were not material." Another variation on this wording is to say "primarily caused by . . . ."

In reality, this often means that the accountant has one or two possible reasons for the net direction of the variance. The unexplained portion is small, so further investigation is not required. The risk, however, is that the netting of both positive and negative impacts causes each to mask the other. For example, a $500,000 positive trend offset by a $501,000 negative issue shows up as a net $1,000 variance. The financial analyst would see this small number and likely pass further investigation. With a multitude of items going back and forth, all finance wants to do is provide a simple answer. Based on this, operating managers quickly realize that finance often fails to understand the complexity and the key drivers of the business.

Finance uses the language of accounting—not the language of operations for variance explanations.

Finally, finance uses the language of accounting—not the language of operations for variance explanations, the most dominant business analysis tool used by finance. This can take many forms, such as comparison of actual results to budgeted amounts, comparison to prior periods, or comparison to standards. Manufacturing companies that use standard cost systems often further divide standard cost variances into component parts such as price, efficiency, and usage variances. Finance professionals spend most of their nontransactional processing time computing and analyzing these variances.

Finance professionals refer to a "favorable purchase price variance" to say that the company paid less for items than they thought they should. But is it really a "favorable" effect if the company had to buy twice as much as needed to get the lower price? Similarly, if plant accountants discuss "absorption variances," operational employees may wonder if new clay has been found to stop oil spills. The point is that finance must translate its message into the language of operations to embark on the road to becoming business partners.

Even with a clear translation of the tool, trouble still exists. To explain financial variances, a person must first understand how they are calculated. This understanding requires that the calculations be converted from a financial formula into operational terms. An operating manager then provides explanations of what happened within the business to explain the results achieved. To test whether this explanation is adequate, the financial analyst must convert the explanation back into financial terms. Again, throughout this process, operations supports finance, a situation that does little to achieve finance's goal of business partnering.

SENDING THE WRONG SIGNALS

As troublesome as these first four problems are, they pale in comparison to the fifth problem with variance explanations: In some cases, variance analysis sends the wrong signals to operations.

For example, the absorption variance reports a "favorable" variance when factories produce more products than requested. This favorable report reflects the capitalization of more fixed costs into inventory. Many plant managers have deliberately overproduced to achieve favorable absorption variances. For companies focused on just-in-time or other agile production environments, this type of action violates the basic goals they seek to achieve. Not only is it *un*favorable, it undermines the entire production philosophy. As such, it is little wonder that finance fails to be respected.

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This problem affects the service sector as well. For instance, a favorable spending variance in the sales expense category may mask a failure of a salesperson to get in front of customers. Generating a favorable purchase price variance may be more the result of overbuying of quantities rather than effective purchasing techniques. An unfavorable budget variance in the customer call center could just as easily reflect higher activity volume, due to greater sales, as it could any problems in the call center.

As a result, financial variance explanations make it difficult to really know what is going on and why. As the key tool used by finance, it is severely broken and not effective for the business. As such, operations has trouble accepting finance as a business partner.

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To change this perception, finance professionals must change the tools used to add value to operations. Problems with existing tools include the following:

- Not produced on a timely basis;
- Focused solely on an accounting time-frame;
- Too aggregate in their view to truly understand operations;
- Spoken in the language of finance; and
- Often reflect the wrong measures.

FINANCE'S TOOL FOR BUSINESS PARTNERING: PREDICTIVE LOGIC ANALYSIS

If finance is to become a true business partner in the 21st century, new tools must be used. These tools should do the following:

1. Focus on predicting the future, instead of reporting the past.
2. Report on an operating cycle rather than a reporting cycle.
3. Reflect the details of the business rather than an abstract aggregate result.
4. Speak the language of operations rather than the language of finance.
5. Align the measures examined with achievement of business strategy rather than merely reflecting the movement of numbers.

To predict the future, companies will replace financial variance explanations with the use of predictive logic diagrams. Variance

explanations look at the past, whereas predictive logic diagrams examine the future. By looking forward, a company still has time to change the results and positively affect the business.

Exhibit 1 illustrates a predictive logic diagram (PLD). In this example, the company sold home improvement products through a direct sales force. Reaching quarterly revenue targets seemed to be a constant struggle. By the time the financial information was calculated, there was little time left to try to improve results. Typical reactions were to launch an ad campaign seeking to develop higher revenue. Rarely did this achieve its goal.

Question-and-Answer Format

Instead of variance analysis, a PLD was constructed. Starting with revenues, the Arthur Andersen team worked with finance to build the logic backward. Construction of a PLD is illustrated by working in a question-and-answer format. One branch of the diagram was filled as follows (from right to left):

Construction of a PLD is illustrated by working in a question-and-answer format.

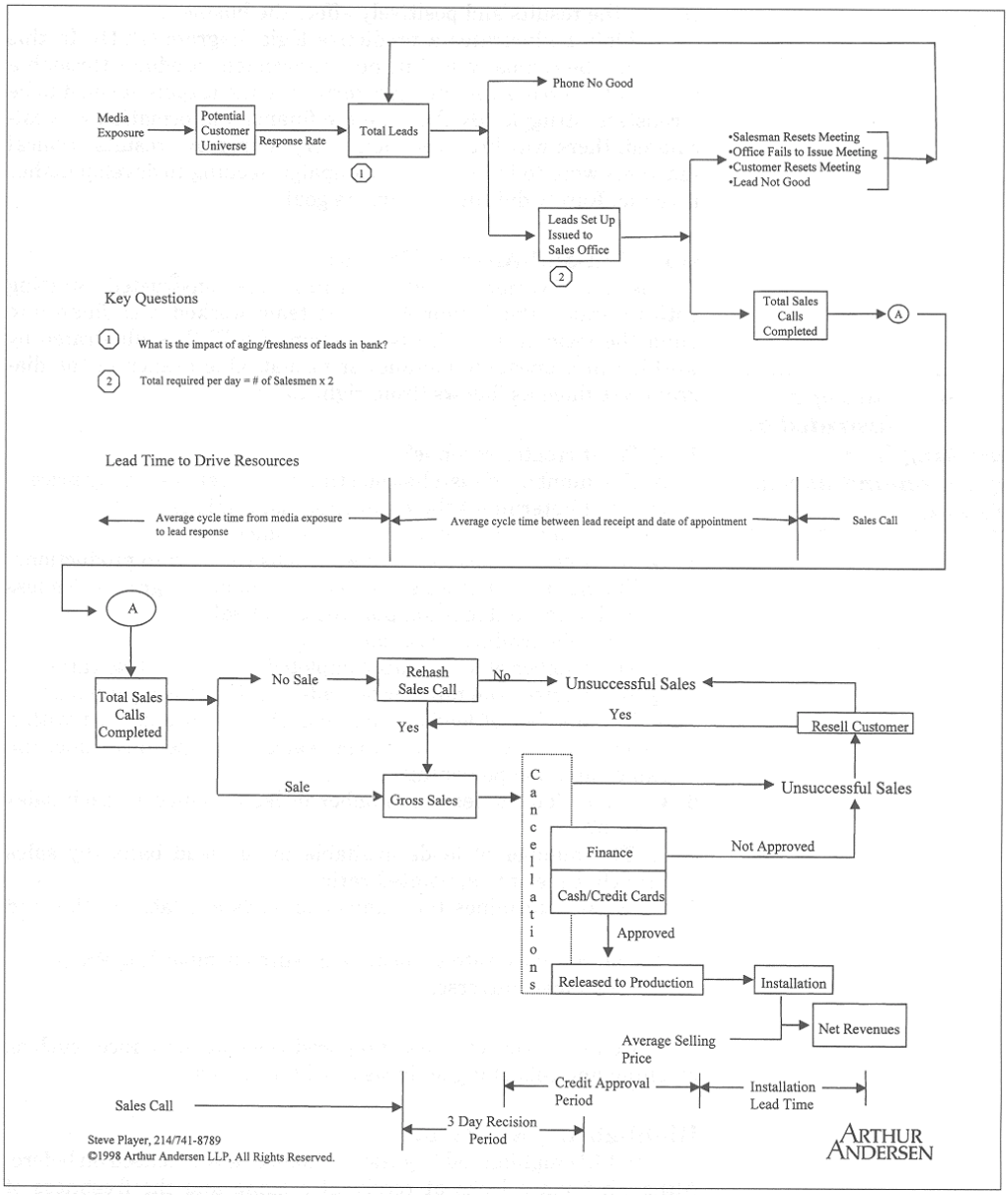
1. Q. What creates revenue?
   A. The number of installations times the average selling price.
2. Q. What determines the number of installations?
   A. The number of jobs released to production.
3. Q. What determines the number of jobs released to production?
   A. The number of gross sales clearing financing (gross sales less cancellations and less unapproved credit sales).
4. Q. What determines gross sales?
   A. The number of sales calls completed times the close ratio.
5. Q. What drives the number of leads of sales calls completed?
   A. The number of leads issued to each sales branch (set with a goal by corporate policy of two per salesperson per day) times the call completion percentage.
6. Q. What determines the number of leads issued to each sales branch?
   A. The number of leads available in the lead bank (by sales branch) times the appointed ratio.
7. Q. What determines the number of leads available in the lead bank?
   A. The response rate to media exposures bombarding the potential customer universe.

Once this basic detail was prepared, additional nuances such as reselling and rehashing activities could be added.

Highlighting Key Issues

The PLD highlighted key issues finance never focused on before. Although finance looks at receivables aging and the freshness of inventory, both items are less significant than the freshness or aging of leads in the company's lead bank. The lead bank may be far more critical to the financial health of this company.

Exhibit 1. Example of a Predective Logic Diagram



A PLD allows a company to focus on the bottlenecks within a process. For example, if management had $1 million to invest in improving operations, where should it be applied? Which of the traditional finance tools could be used to answer this question?

The PLD can be used to predict the answer. Historically, the company would have launched a media blitz. The PLD shows that a media blitz would merely add more leads to the lead bank. Eventually this might pay off, but certainly not quickly and only at the rate by which the branch sales force could meet and close the leads.

Hiring salesmen would open up a key bottleneck. Each additional salesman would provide 12 to 14 new sales calls per week. However, the biggest impact could well be investing in sales training. Increasing the sales close ratio not only improves revenues but also dramatically improves profitability as most other costs remain the same.

Whereas each company's unique environment determines the leverage point most likely to succeed, a PLD allows a company to rapidly predict results.

Whereas each company's unique environment determines the leverage point most likely to succeed, a PLD allows a company to rapidly predict results. In addition, this tool can provide an understanding of how quickly an organization can respond. Connecting a cycle time map to the PLD provides response estimates. As seen in Exhibit 1, the cycle time map stretches across the diagram to identify key time-frames. Beginning at the right and working backwards, the key time-frames are blocked and noted. The analysis results in the following times:

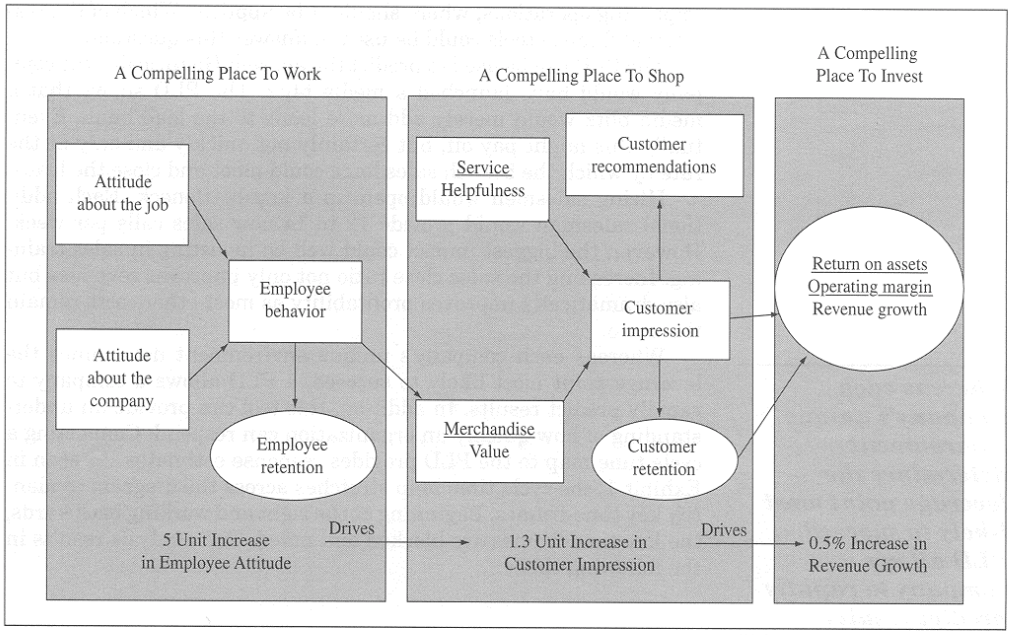
- Installation time.
- Credit approval period.
- Sales call.
- Appointment scheduling (average cycle time between receipt of leads and date of appointment).
- Exposure response time (average cycle time from media exposure to lead response).

The combination creates the total cycle time needed to generate revenues. It also allows a company to predict how quickly it can change revenues.

PREDICTING RESULTS

Companies are already using these techniques. One national distributor monitors the daily shipments from its warehouses. This information is fed to a model, which predicts on a daily basis the month-end income statement. It adjusts for seasonal, day-of-the-week, and holiday fluctuations. As such, a problem can be detected by the seventh working day of the month. When detected, promotional and telemarketing efforts are applied to bring performance back in line with expectations. In this company, finance truly helps manage the company. It uses predictive skills to be a player—not just the scorekeeper.

Exhibit 2. The Employee-Customer-Profit Chain



For example, Sears developed an understanding of its employee-customer profit chain, which can be used to predict results. Exhibit 2 illustrates the model in place at Sears (Quinn, 1998).

Sears found that an employee's behavior is driven by the employee's attitude about his or her job and company. This behavior has a direct impact on the service helpfulness the employees provide to Sears customers.

Sears also found that employees' service helpfulness, combined with merchandise value, creates the overall customer impression. This leads directly to understanding how customer impression affects customer retention and customer recommendations.

Higher customer impression, retention, and recommendations were then tracked to an increase in revenue growth. Revenue growth directly affects operating margin and return on assets.

It sounds simplistic to say that happy employees generate more satisfied customers, who in turn buy more goods. The difference at Sears is its ability to quantify this model. A five-unit increase in employee attitude was to drive a 1.3-unit increase in customer impression, which was found to drive a 0.5 percent increase in revenue growth. At a company the size of Sears, that kind of growth can have a huge impact on the bottom line.

The key is the ability to predict what will happen. Finance professionals who can master tools such as PLDs will be able to predict and produce a business partner role for themselves.

REFERENCES

Quinn, R. T. (1998). The employee-customer-profit chain at Sears. Harvard Business Review, January/February, 83–97.