# BUSINESS ACUMEN, BEHAVIORAL FINANCE AND THE ROLE OF THE CFO

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***CFOs Need to Evolve to a More Strategic Focus***

There has been extensive debate over the past years over the role of the CFO and its need to evolve to a more strategic conception. However this debate has generally not touched on how the CFO's role should encompass, if at all, human resources and organizational change and organization building.

This article shows how a new innovation in management – assessment and development of business acumen in managers - promises to revolutionize selection and development of managers who can have a disproportionate impact on increasing the market value of the companies they work for, and in this process, lead to new ways of managing and making profits for them.

The CFO must play a crucial part in developing this program and function in order to optimize his or her own impact on the development of the financial performance of the company. As such, the role of the CFO will need to include not only strategy, consistent with the emerging consensus, but also the strategic talent management and development functions, from their financial and capital perspectives.

This new approach forms part of the new disciplines of behavioral finance and behavioral economics. CFOs must become aware of this new approach so that they can take advantage of new ways to build organizational value and achieve competitive superiority for their companies.

***In Order to Meet the Challenges of an Evolving Global Market***

Companies worldwide are moving from strength to strength. But competition is growing, forcing companies everywhere to become more creative in how they use their assets – financial, human and physical. CFOs are under pressure to become more strategic and creative in order to help their companies in this relentless drive.

In the earlier stages of economic growth, the challenge for CFOs was primarily technical, namely how to use financial assets to the best advantage for their companies and shareholders. However as organizations have become ever more sophisticated in their use of financial structuring and engineering techniques and as they have become more

expert in their use of leverage and other organization building techniques such as mergers and acquisitions, the bar has been lifted substantially. Today CFOs are expected to be expert in these areas and to be still taking the lead in yet other areas which can provide competitive advantage from the financial perspective.

Some of these new challenges include:

- Pressure to adopt different and more flexible organizational, financial and capital structures in order to compete with new financial approaches from hedge funds and other global sources of capital.
- The move to private equity and away from public ownership.
- Integrating human and financial resources so that the concept of financial leverage can be enhanced using human resources and talent management as strategic valuation-enhancement techniques.

### *CFOs Have Not Been Involved Enough on the Human and Financial Cultural Issues*

The central challenge of the CFOs has been to move up from a purely financial view of their role to a more encompassing view. This must take into account strategic, execution and talent issues. Only in this way can the CFO be seen as a strategic rather than as a technical resource.

However CFOs and financial management have not traditionally been seen as having this broader view. Where CFOs have gained such a reputation it has been in the strategic area. But the image of CFOs and financial management is that they are generally divorced from human resource and talent management issues. As competitive factors increase in strength, the global war for talent and its leveraging for valuation enhancement purposes has become very much more important. It is in this area that CFOs and financial managers face some of their largest challenges.

The critical driver of excellent financial performance and competitive superiority is, at the end of the day, not just financial sophistication, bur rather the level of business acumen possessed by all managers and staff of a corporation. This is not just a matter of education and experience but also a matter of financial personality.

Most people do not naturally possess financial or business acumen. However the good news is that business acumen can be developed and improved. If this is not done, financial structuring and engineering techniques by themselves may not help much and in some cases can even act to retard the financial performance of managers by allowing them to relax and to erroneously believe that valuation improvement is a technical rather than a strategic and behavioral issue.

CFOs and financial management need to focus more on the areas of human resources, talent management and executive development in order to gain leadership over the next major phase of competitive evolution., Otherwise they will be seen as technical experts who are necessary for good financial management but not be seen as part of the

solution in the talent management and development side of the strategic valuation equation.

### *But New Research is Revealing How Financial Culture and Financial Outcome Are Linked*

Traditionally there has been little or no research that is focused specifically on the linkage between behavior and financial outcome. Current leadership approaches are based on personality and competency approaches. While these can result in significant insights for leaders, they were never designed to provide insights into their financial behavior and impact. This has resulted in CFOs and financial management having little to do with leadership assessment and organizational improvement from a financial perspective since there were no models or approaches that showed how this could be achieved.

That situation is now changing. My company, the Perth Leadership Institute has conducted research into the linkages between behavior and financial performance (see the book by Dr. E. Ted Prince, "The Three Financial Styles of Very Successful Leaders", McGraw-Hill, 2005). This has led to the development by Perth of business acumen assessments and approaches for improving it. These assessments can be quickly completed online and can show a manager their level of business acumen and how it can be improved. This innovative new approach is starting to be used by some of the largest companies in the US.

The approach is based on a model of behavioral finance. Behavioral finance is the new science which integrates behavior with financial analysis and planning. Until now there was no such method – either you adopted a behavioral approach with no financial linkage, or a financial approach with no behavioral underpinnings.

Behavioral finance teaches that all humans have unconscious biases that adversely impact the outcome of their decisions. This occurs especially in the area of finance and economics. It is only by understanding these systematic biases that we can make better financial decisions.

Behavioral finance and economics have developed a framework that applies to groups of people who make decisions. However it has not developed a framework by which we can predict the financial impact of these biases at the level of a specific individual, a specific team or a specific company. My company has addressed this issue and resolved this problem. This allows to make quantitative predictions for specific individuals, teams and companies.

The Perth model links managerial behavior with financial performance and company valuation. It identifies the Financial Signature® of a manager and shows what the impact of that will be on the financial performance and valuation of an organization – and on that manager's own potential to achieve personal wealth – and then shows the manager what he or she needs to do to impose that valuation and wealth creation outcome. It is an intriguing and innovative new approach that is transforming the way that we achieve superior competitive and valuation outcomes.

### *The Financial Signatures® of Managers are a Key Factor in Financial Outcome*

What the research by the Perth Leadership Institute shows is that we all have a characteristic approach, personal to us all, that determines how we make financial decisions. These decisions are driven by a set of innate personal financial traits, of which we are usually unaware. These financial traits lead us to make financial decisions in a particular way. Once we understand that particular way, or style, it is possible that we can predict how a particular executive, or individual, will make financial decisions. This, in turn, allows us to predict the financial performance of that executive team.

Perth calls these personal financial traits, the Financial Signature of an individual. We discovered nine Financial Signatures in the research. Each of these was linked with a characteristic impact on corporate financial performance and valuation. Of course, in most cases, the executive or team was totally unaware of this so they themselves could not predict how they would perform from a financial perspective. But an observer who understood the Financial Signature model would be able to predict their financial performance if he knew their Financial Signatures.

Unfortunately not all Financial Signatures are linked with profitable performance. In fact, the reverse is the case. What the research discovered is that the majority of individual executives will have personal financial traits that do not lead, on their own, to profitable financial performance and a valuation increase. In fact the majority of executives Perth have tested using its proprietary instruments for assessing Financial Signature will have one that will lead either to unprofitable performance, or to no profits.

This research therefore categorizes the nine Financial Signatures into three financial styles, the Value-Centric, Balanced and Resource Centric styles. Executives with a Value-Centric style will have profitable performance over the longer-term, even though in the short-term, on occasion they may make losses. Executives with Resource-Centric styles will make losses over the longer-term, even though in the short-term, they may well make profits. And executives with Balanced styles will, over the longer-term, never make money, or lose much money either.

The research and resulting approach is bottom-line oriented and focused on organizational value creation. It recognizes that many leaders who would not rank highly on traditional personality and competency-based leadership ratings are often highly successful leaders who create outstanding products, profitability and value for their stakeholders.

### *Humans Need to be Viewed as a Particularly Important Form of Capital Asset*

The major insight from work in behavioral finance and the Perth model are that humans are themselves a capital asset, one that has its own independent impact on financial outcomes, and independent of other factors of production such as capital and assets. There are a number of key implications for CFOs and the financial management of companies stemming from this research. These include:

- **Staff are capital assets, just as physical and financial assets are:** every individual has a financial impact and this impact can be measured quantitatively. In principle every individual has a measurable impact on capital generation in the company and we can, again in principle, measure this capital generation impact over the lifetime of his or her employment by the company.

- **Hiring is another form of capital enhancement:** we cannot divorce hiring decisions from capital generation; if a company is enhancing capital generation through profitability, or raising debt or equity it could well be consuming capital through the types of people it is hiring; hiring decisions are as much part of capital generation and structuring as are more conventional decisions regarding capital raising and financial structuring. This is akin to quality improvement where one must take into account employees and their training since, even if quality strategy is correct, quality will decline if the human part of the equation is not part of the quality system.

- **The wrong sort of hires and promotions result in capital consumption or sub-optimal capital generation:** as above, it is not only hiring, but also how we promote and develop that will impact capital generation and financial performance.

- **Talent management is merely another form of financial engineering based on behavior:** if we do not take into account how we manage and train staff and managers, we are missing a vital, if not the vital, tool in financial engineering, namely financial engineering through behavioral change. Talent management is a key driver of financial performance through the medium of the capital generating impacts of behavior.

- **Budgeting and forecasting are impacted by the financial signatures of those who create the forecasts and budgets:** we cannot see forecasts and budgets as being independent of the behavior of the people who created them.

- **Cost of capital is also impacted by financial behaviors:** Certain financial signatures will result in a low cost of capital while other types of financial behaviors will results in a high cost of capital.

- **The Financial Signature® of the CFO is a key factor in driving valuation performance:** almost everyone acknowledges that the CEO is a key factor in financial and valuation performance, and would also accept that his or her Financial Signature is a critical part of this equation. But the importance of the CFO and their Financial Signature is rarely acknowledged in this context. Not only does the CFO drive financial performance in how they approach their strictly financial tasks, but their own behavior is also a critical element. Few CFOs understand this, and therefore are lacking a key tool for driving the financial performance of their company – their own financial behavior.

Taking the financial style and behavior of managers and staff into account requires that CFOs take a more holistic perspective on their role. This is precisely what they need to do to assume a more strategic role. A strategic financial function must take strategic

talent management into integral account. CFOs who do not realize this are missing invaluable opportunities to improve the financial performance and valuation of their companies.

Such a view requires that CFOs assume a key role in building the organization generally from a strictly financial and valuation perspective. The only other officer who is charged with doing this is the CEO, but even a CEO will rarely take on the responsibility for integrating talent management with financial and valuation performance. This is the unique function of the CFO. CFOs need to become key managerial drivers in building the financial culture of the company in order to build a more profitable financial culture and to improve the valuation outcome of its operations.

Finally, the behavior of the CFO himself is a vitally important factor in financial and valuation performance. For many CFOs, their lack of understanding of talent management for others also transfers into lack of awareness of their own behaviors and their impact. Of all the managers in a company, the CFO needs to understand the financial and valuation impact of their own behaviors, both so that they can improve their own impact, as well as that of others in the company.

### *There are Quick and Effective Ways to Launch Change Programs*

Where should a CFO start and what areas should they tackle in building a program of organizational change? The following are the basic building blocks:

1. Individual financial impact programs for the CFO and financial management.
2. Team financial impact programs for the C-levels and senior operating management.
3. Building a profitable financial culture through talent management and development.
4. Integrating these approaches in mergers and acquisitions.

### Individual financial impact programs for the CFO and financial management

CFOs should launch a program focusing on themselves and their financial management team. This will train them in the approach and function as a learning opportunity for themselves and their management team in rolling out the program to other parts of the organization.

For many CFOs and financial managers this may be their first real opportunity to examine in detail the precise links between behavior and financial outcome. They may be working with the HR function for which this will also be a learning opportunity for the same reasons. In addition, such an opportunity will engage the HR and leadership development functions from a financial perspective, something that is relatively new for HR but yet is important for that organization also.

### Team financial impact programs for the C-levels and senior operating management

The CFO usually has a close working relationship with the operating management at the C-level. However this does not necessarily mean that he or she believes that they are on the same wavelength. Rather, it is more frequently the case that the CFO feels somewhat besieged, and feels that the operating managers do not take into account financial considerations which are left purely to the CFO to deal with.

The CFO has a vested interest in bringing about more understanding of financial issues and improvement possibilities for the C-level of management. By making them aware of their own financial traits and the linkages between their own behavior and company financial outcomes, he can provide the behavioral base for true change at the top levels of management without being seen to impose on it financial approaches with which they are not in agreement or which they see as being ponderous, onerous, or even worse.

**Building a profitable financial culture through talent management and development**

This is the core of an organizational financial improvement program. The CFO must accept that financial change through behavior must mean that he has to impact human resources and talent management decisions. This does not mean that he has to implement them; this is a matter for HR. But the CFO must make his or her perspective clear to HR so that the latter can take his views and needs into account in HR and talent management and development programs. Unless the CFO does this, HR is unlikely to make the explicit connection between HR decisions and programs and financial outcomes, including those desired by the CFO.

This means adopting the Financial Signature® approach in recruiting, promotion and development of staff. This includes the following:

a. Executive development programs.
b. Programs for high potential emerging managers and leaders.
c. Succession planning programs.
d. Business acumen programs for all managers and including managers of cost centers, managers of technical units and managers in sales and marketing functions.

Unless the CFO is actively involved with HR in designing these programs and this approach, their role is unlikely ever to be transformative since they are not impacting organizational culture and behaviors.

**<u>The vital role of the CFO is in building a profitable financial culture.</u>** This is change from the ground up rather than from the income statement down. It explicitly acknowledges that the basis of a profitable financial culture stems from people and that, if this side is looked after well, profits and the correct valuation outcomes will follow.

**Mergers and Acquisitions**

CFOs involved in mergers and acquisitions – and indeed, any other form of business combination or structure - need to quickly introduce programs in improving financial impact and in business acumen for a number of reasons:

a) To make the initiative more commercially successful than it might otherwise have been.
b) To ensure that the right managers are selected, recruited, promoted or assigned to the right jobs.
c) To ensure that the right development programs are launched for managers in the new, merged or divested enterprise.

This will involve working with HR in a planned program from the beginning to the end of the M&A process including:

1. Target screening.
2. Composition of the M&A team.
3. Due diligence.
4. Integration planning.
5. Implementation.
6. Post-integration review.

***CFOs Must Implement These Approaches to Achieve Their True Professional Potential***

CFOs, like all other top managers, cannot rest on their past achievements. The nature of competition dictates that they must constantly improve themselves and their strategies to increase financial performance. Being a good technical CFO is no longer enough to meet the competitive requirements of innovation for valuation enhancement. In order to keep pace, CFOs must identify new ways in which to drive the process of organizational financial improvement so that they continue to be seen as value-added players in this area.

Ultimately CFOs must drive towards the achievement of a more profitable financial culture, starting with themselves and their financial managers and continuing to the rest of the organization, both the top and the less senior levels. To do this they must become more involved in integrating human resources and talent management strategies into their work for the purposes of increasing financial and valuation performance of their companies and themselves. This is the lesson that emerges from the new behavioral finance and business acumen approaches to management and company valuation improvement.

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