ICAEW FINANCE & MANAGEMENT FACULTY

FINANCE'S ROLE IN THE ORGANISATION

FINANCE DIRECTION INITIATIVE

FINANCE DIRECTION INITIATIVE

Finance's role in the organisation considers the challenges of designing successful organisations. The document consists of two articles previously published in *Finance and Management*, the ICAEW's Finance and Management Faculty Magazine. It forms part of our exploration of the role of the finance function, the first theme for the faculty's thought leadership programme. The other two themes are managing the future and non-financial measures.

ICAEW is an independent professional body, working in the public interest as required in its Royal Charter. As a world-class professional accountancy body, ICAEW provides leadership and practical support to over 136,000 members around the world, working with governments, regulators and business to maintain the highest standards. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

The ICAEW's Finance and Management Faculty provides its members with up-to-date business ideas; the latest management tools; unbiased and independent information and helps them to become an effective part of the management team.

We welcome comments on this work and the other themes in this programme. Please email rick.payne@icaew.com.

November 2009
Reprinted February 2011

ISBN 978-1-84152-855-7

FINANCE'S ROLE IN THE ORGANISATION
PART 1

How does the finance function best fit within the design of an organisation? Here **Rick Payne** looks at current practice and highlights the way thinking in this area is developing.

The role of finance functions, their contribution to organisational performance and how such contribution can be enhanced need close scrutiny. This has always been the case but is made more urgent now because finance functions are implicated in both the successes and failures highlighted by the current financial crises. Their role will be examined along with wider questioning of the effectiveness of the 'Anglo-Saxon' form of capitalism.

You, our readers, are well placed to contribute to this scrutiny and inform the faculty's thought leadership programme on the role of the finance function. This is the first of two articles which highlight some of our thinking to date and the challenges and questions this raises. We would welcome your input on any of these points – and in raising those we may have missed (please see contact details on page 7).

In this month's article we highlight some questions on the role of the finance function and emphasise the importance of organisational design. The second article will consider the need to consciously and proactively build functional structures and the challenges involved – and here, your insights and examples would be particularly valued.

SHOULD WE BE PROMOTING INCREASED INFLUENCE FOR THE FINANCE FUNCTION?

The 'Anglo-Saxon' form of capitalism which promotes free markets and light-touch regulation has been associated with the increasingly widespread acceptance of the need for an influential chief financial officer (CFO) supported by a strong finance function focused on business partnering. This is because of:

- the growing perception that measurement and financial information are imperative in running an organisation and monitoring its success in highly competitive environments – witness the focus on shareholder value and on monitoring cash and costs;
- the globalisation of capital flows with investors, lenders and regulators expecting to deal with a professional CFO and finance team, even in countries where different institutional models had previously prevailed;
- the increasing importance and sophistication of financial engineering in organisations;
- global governance/regulatory changes which have emphasised the role of finance. These include the focus on financial governance and controls after the WorldCom and Enron scandals and the widespread adoption of International Financial Reporting Standards; and
- the ability of the accounting profession to attract and develop talented individuals who have the necessary skills and commercial acumen to take on senior organisational roles.

Reports from major consultancies, the big four accounting firms, professional bodies and other commentators have also played their part. They urge finance functions to take leading roles in strategy development, decision making and organisational transformation. Those who appear to have achieved such positions are lauded and the laggards are advised to catch up.[1]

The model has also been promoted and adopted in the public sector. In the UK, Gordon Brown announced in 2004 that all departments should have a professional finance director (FD) with a seat on the departmental board.[2] The Conservative party says it will take things further next year, if elected, by re-defining the FD role as the second most important in a department and making the head of the government accounting profession a full-time post.[3]

But what rigorous evidence is there to support the argument that powerful CFOs and influential finance functions are essential for organisational success? Experience, anecdote and surveys provide some important evidence of the positive role that finance plays. Therefore we might be tempted to take the hypothesis as a given.

However, we can infer from some leading economies that there are different workable models where the finance function has less influence. For example in Japan and Germany the role of the FD is often not as prominent and chief executives are less likely to come from finance backgrounds. They also have fewer accountants per head than in the UK and the USA.

What rigorous evidence is there to support the argument that powerful CFOs and influential finance functions are essential for organisational success?

Some have argued that strong finance functions focus too much on measurement, analysis and control thus stifling initiative and innovation. It may be more important that good financial disciplines are distributed throughout the organisation.

Organisational performance is fundamental to global and national performance – economically, socially and environmentally. If in turn such performance is significantly influenced, for good or ill, by the role of the CFO and the finance function it is imperative we deepen our understanding of what works, how and in what circumstances. So where to start?

THE ROLE OF THE FINANCE FUNCTION CANNOT BE CONSIDERED IN ISOLATION

First of all we cannot fully understand the role of finance by considering it in isolation from other functions such as human resources, marketing and information technology. Although the underlying reason for the existence of these functions is the gains that can be made from specialisation and the division of labour, co-ordination is required if an organisation is to achieve its objectives. Time must be spent on the alignment of goals, processes and behaviours across functions with significant risks arising through communication problems and misdirected effort.

Management exhortations to break down organisational silos are indicative of the scale of the problem. One of the early actions of Carol Brantz as the new chief executive officer of Yahoo! was a restructuring designed to remove 'the notorious silos' to enable better focus on the customer. In addition, specialisation by its nature means that different functions have different strengths and weaknesses.

A focus on particular organisational tasks enables a function to develop an in-depth knowledge in its field and to deal efficiently with problems in its area of expertise. The downside can be blind spots and biases which will result in inappropriate interpretations and responses to signals from the organisational environment. Stereotypically, if there is an organisational problem, finance wants to measure it and set targets for improvement, HR suggests a training and development initiative and IT knows that the latest software will provide the solution. Therefore we need to organise such that the strengths of specialisation are exploited and the weaknesses counteracted.

LOOKING AT ORGANISATIONS FROM ONLY ONE PERSPECTIVE LIMITS UNDERSTANDING

Secondly, we will gain greater insight by considering different ways of looking at organisations.[4] The discussion above covers both the machine-like nature of organisations by examining how specialised parts can be made to work together, and the organisation as an organism which needs to respond to its environment. Other perspectives include looking at organisations as cultures, political arenas and complex systems subject to ongoing processes of change.

The importance of culture in organisational performance has long been recognised, albeit with a wide range of interpretations of what culture is, why it is important and whether it can be managed. Clearly, values, norms, shared meanings, symbols and stories are important in understanding organisations and provide potential levers to effect change. Therefore we need to look at the ways functions both construct organisational culture and are influenced by it. For example finance may set out to impose strict budgetary controls and promote cost consciousness but accept greater flexibility than originally planned because of a 'resistant' culture.

Viewing functions as political interest groups highlights the risk that functions may pursue their own interests at the expense of the organisation as a whole. One of the reasons that Motorola has struggled to keep pace with Nokia has been the dominance of engineers who have focused on technical excellence rather than market requirements. Functions can gain power, status and financial reward by taking on greater responsibilities and growing in size irrespective of whether that is best for the organisation. This is particularly true of high status tasks with no obvious home, notably strategy development and implementation. It is safe to assume that finance, human resources and most other functions rarely make a case for reducing their influence on strategy – and that the same is true for their advisers.

Lastly, organisations can be seen as complex systems which are constantly changing and adapting. This underlines the need to be careful of viewing functions as fixed groups carrying out predetermined tasks. This view also shows us that the impact of functions on organisational success cannot be understood through simple, linear cause and effect relationships.

Functional roles and relationships change and adapt on an ongoing basis sometimes gradually and sometimes in large leaps, sometimes from the impact of the environment and sometimes through forces internal to the function. Functional staff tweak processes, functional heads embark on transformation programmes and takeovers create new functional structures. Importantly this approach also highlights the paradoxes of organisation. For example managers want both to be in control and allow adaptability, and they want to organise functions with clear boundaries to gain the benefits of specialisation but also require collaboration and integration.

WHAT DO MANAGERS NEED TO CONSIDER IN DESIGNING ORGANISATIONS?

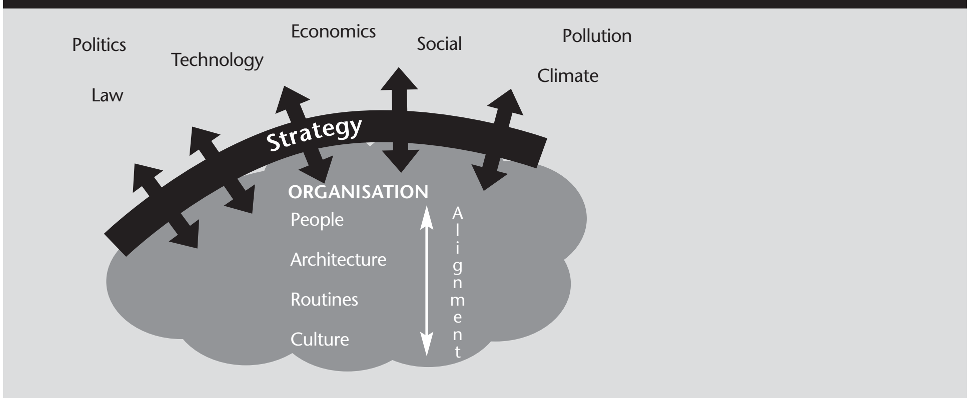
Both of the above sections lead us to explore the broad features of organisational design. Below we look at four key aspects – the elements of organisations; organisational strategies; the organisation's environment; and alignment within the organisation. While in no way comprehensive, these aspects can be built into a framework which helps us to integrate some of the perspectives above and to take a holistic view of organising.

The organisation can be viewed as composed of the following interrelated elements (see Figure 1):

- people (employees, contractors and owners – always bearing in mind that as supply chains grow more complex it is not always clear who is and isn't part of the organisation);
- architecture (for example reporting lines, responsibilities, governance structures and informal relationships);
- routines (for example processes, policies, reward structures and approaches to decision making); and
- culture (relating to values, beliefs and norms of behaviour).[5]

Managers are faced with choices concerning the levels of specialisation, centralisation and formalisation (loosely, bureaucracy) across these elements of organisation. For example, to what extent should finance staff take on broader roles, be organised into dispersed departments across divisions and be subject to standardised, documented procedures? Clearly size has a significant influence on these choices. For example small organisations generally require less formalisation of procedures and policies than large ones.

FIGURE 1: THE BUSINESS ENVIRONMENT



Viewing functions as political interest groups highlights the risk that functions may pursue their own interests at the expense of the organisation as a whole

Organisational strategies can be categorised in a number of ways. However, a key distinction is often made between those organisations which look to produce tailored, differentiated products/services and achieve high margins as opposed to those which focus on high volume, mass markets and achieve appropriate margins through efficiency and low costs. Clearly decision makers will need to consider how the elements of organisation discussed above can be combined to deliver the chosen strategy. Less intuitively, managers also need to be aware that organisational structures influence strategy choice. For example top management teams which have powerful members with finance function backgrounds have been observed to pursue diversification and acquisition strategies.[6]

Organisations exist within complex surroundings and need to respond to a huge range of factors – including political, economic, social, technological, legal and environmental. They face varying levels of uncertainty in each of these interrelated areas and different levels of competitive pressure. For example banks are dealing with the significant regulatory changes already introduced, preparing for further changes and lobbying to influence the outcome.

There are relatively few viable configurations (patterns) of organisation, strategy and environment.[7] An example of a viable configuration would be a decentralised, low formality firm pursuing a differentiation strategy in an uncertain, complex and competitive environment. Many management consultancies and high technology companies are such cases.

Alignment within the organisation is also important. Such alignment exists when all members of the organisation pursue mutually understood purposes, strategies and goals with a shared culture and values within appropriate structures. A high degree of alignment should maximise the chances of organisational success through enhancing collaboration and achieving complementaries. Lincoln Electric Company which provides arc-welding equipment is a well known case in point. It is renowned for its successful use of piecework incentives which other companies have failed to replicate. Lincoln has achieved this because other factors are in alignment notably individual bonuses based on co-operation, tight individual accountability for quality, tolerance of relatively large inventories, employment security and trust in management.[8]

Too much alignment is also a possibility. This is particularly the case when the environment changes and over-alignment restricts the range of organisational responses. An organisation committed to high growth through innovation and marketing sophistication may find it difficult to adapt to economic downturns when cost efficiencies and cash conservation have to be the focus. Careful thought is required to manage this.

CONCLUSION

From the above we conclude that:

- there is no 'one-size-fits-all' solution to organising functions effectively and no one function which should automatically command higher status;
- decision makers need to think through the complexities of organising to arrive at solutions which best develop and implement organisational strategy on a sustainable basis. This includes the need to focus on the optimal alignment of organisational purpose, strategy, values, goals, structure and culture – sufficiently aligned to be highly productive but not overbearing such that the organisation is unable to change and adapt; and
- the role of the finance function and its potential to contribute to organisational performance will depend on the particular circumstances of an organisation. Decision makers must ensure that finance is appropriately positioned within the overall structure.

Next month, we consider in more detail the challenges organisations face in building functional structures.

REFERENCES

1. See for example IBM (2008), 'Balancing Risk and Performance with an Integrated Finance Organization. The Global CFO Study 2008'.
2. Government Finance Profession in association with CIMA (2007), 'Government Finance Profession: A Celebration of 25 years'.
3. Conservative party website accessed on 30/6/2009 'It's Your Money. A New Plan for Disciplined Spending in Government'.
4. Morgan G. (2006), *Images of Organization*, 2nd Edition, Sage Publications, London.
5. Roberts, J. (2007), 'The Modern Firm: Organizational Design for Performance and Growth', Oxford University Press, Oxford.
6. Finkelstein, S. (1992), 'Power in Top Management Teams: Dimensions, Measurement and Validation', *Academy of Management Journal*, 35(3), 505-538.
7. Miller, D. (1996), 'Configurations Revisited', *Strategic Management Journal*, 17(7), 505-512.
8. Roberts, J. (2007) *op. cit.*

FINANCE'S ROLE IN THE ORGANISATION
PART 2

In this second article focusing on organisational design, **Rick Payne** looks at the ways for finance to approach structure and functional organisation within business.

In last month's article, I argued that there is an urgent need to consider the role of the finance function and its influence on organisational success. I contended that in order to do so we need to avoid considering finance in isolation from the organisation as a whole and that we need to take multiple perspectives on organisations. The importance of developing viable configurations of organisation, strategy and environment together with achieving optimal internal alignment was also emphasised. Understanding this overall context provides an essential foundation for examining the challenges of organising functions (such as finance, HR and IT) and their relationships.

This concluding article sets out the argument that organising functions effectively must be done consciously and proactively. It also considers the problems in doing so:

- we do not know enough about how functions contribute to organisational performance or have sufficient guidance on what functional structures work in what circumstances;
- changing environments mean that functional structures need to be regularly reviewed and adapted; and
- even when the desired structures have been identified, building that structure is not straightforward.

A 'DO NOTHING' APPROACH TO ORGANISING IS NOT A VIABLE OPTION

The degree to which organising can take place consciously and rationally in a planned and managed way is open to debate. Should we even try? It is conceivable that a laissez-faire approach may lead to successful functional and organisational performance. Maybe we can rely on the fact that functions inevitably compete for scarce resources and influence. At best this competition leads to:

- power residing in the functions which contribute most to organisational performance;
- continuous improvement;
- the interplay of ideas; and
- responsiveness to the environment and the prevention of organisational inertia.

However, competition within an organisation operates in a distorted market. In particular, functions are often monopoly suppliers and the market is subject to imperfect information. Moreover functional goals may not be aligned with organisational goals and functions sometimes develop distinctive sub-cultures. While these sub-cultures may have some value in countering the risks of over-alignment they will also undermine any desired organisation-wide culture. The result may be dysfunctional conflict and coordination problems. Therefore at least some degree of management intervention is required. But on the basis of what evidence?

ORGANISING FUNCTIONS AND ORGANISATIONAL PERFORMANCE – MANY QUESTIONS REMAIN

While a great deal of work has been carried out on design principles for organisations as a whole, more detailed work is required at the functional and inter-functional level. Key questions remain. For example:

- How is functional performance linked to organisational performance?
- How can organisations best manage the balance between the benefits gained through specialised functions and the need for coordination across the organisation?
- Which functions should be most influential in which circumstances?
- What, generally, are the unique 'competitive' advantages of particular functions and what are their likely biases and blind spots?
- What is the nature of conflict and collaboration between functions and how can an appropriate balance be achieved which optimises the overall contribution to organisational performance?
- How and why do functional structures vary across national boundaries?

Organisations will need to decide at which point such outsourcing begins to compromise their own competitive advantage

Despite the lack of rigorous research on these questions, a perceived wisdom seems to exist – at least in the UK and the US. Functions should seek to centralise and standardise low value added work such as transactions processing and payroll through shared service centres or outsourcing the work to third parties. Only staff carrying out more value added work such as business analysis, decision support and strategic input need to be situated closer to business decision makers. Such staff and their functional heads are urged by their advisers to pursue positions as 'business partners', whereby they aim for lead roles in strategy, decision making and driving change.

Where such models fail, this is generally seen as an implementation problem and the risks associated with the model are seen as matters to be managed. For example, failure to achieve cost savings through outsourcing may be attributed to choosing the wrong outsourcing partner. Rarely is it argued that there may be fundamental flaws with the model itself or that the model only works in a limited number of contexts. As an example let's consider in more detail the assertion that functions should seek the role of business partners.

It seems to be assumed that each function will make effective contributions to a wide range of organisational matters with little consideration of why this is likely to be the case. Also, the benefits of specialisation are downplayed as functions strive for the more generalist business partner roles. Their technical and control roles are largely taken as a given. Understandably finance's production of the financial accounts, HR's administration of personnel records and IT's maintenance of existing software are expected to be delivered at low cost to an acceptable standard.

However, there is a risk in taking control roles for granted. The prevention of fraud, complying with employment law and maintaining data security may get neglected, under-valued and under-resourced – until of course something major goes wrong and it is too late.

Moreover, the problems of potential conflicts between business partner and control roles and the fact that not all functions can take the lead simultaneously receive insufficient consideration.

For example, studies of decision making have demonstrated that once an individual has made a significant investment of time and energy into pursuing a particular course of action it is very difficult to change course, even if evidence starts to indicate that the original direction was inappropriate. This 'escalation of commitment' provides a challenge for the chief financial officer (CFO) who has been heavily involved in the development of organisational strategy and is then supposed to challenge and probe organisational decisions. Some CFOs of large organisations we have talked to feel the emphasis on business partnering has been overdone and finance's role in asking the difficult questions is more important.

In addition the potential jockeying for position between functions as they all try to take the lead requires costly time and effort which may only result in the redistribution of power and influence rather than adding value to the organisation.

Faith seems to be being placed in competition, mimicking other organisations, or decision makers being able to make suitable judgements from the individual and prejudiced pitches of each function. We believe more emphasis should be placed on systematic, evidence-based analysis of how best to organise functions so that they work together effectively, the most is made of each function's unique competencies and dysfunctional behaviours are minimised.

CHANGE MEANS FUNCTIONAL STRUCTURES WILL ALWAYS BE TEMPORARY

Even if a successful functional structure is achieved, this is likely to be temporary. References to accelerating change are the clichéd start to many an article on organisations. But while we recommend a more considered understanding of the real pace and relevance of particular changes to particular industries, there is little doubt that there are a number of trends to which organisations need to pay attention. We particularly emphasise the interrelated areas of globalisation, technology change, new organisational forms and sustainability. Each is likely to continue to have a major impact on the most appropriate way for functions to be organised and contribute to organisational success.

For example, outsourcing of functional responsibilities has been a major feature of recent years as technology has enabled transactions processing in cheaper, overseas locations. If there are parallels with other industries, such as the US steel industry,[1] then outsource providers will seek to move up the value chain and take on more and more complex advisory roles. Organisations will need to decide at which point such outsourcing begins to compromise their own competitive advantage. They will need to consider when the often intangible benefits of direct organisational control outweigh the potential efficiencies achievable through outsourcing. In addition the benefits of outsourcing may diminish in the future. There is already evidence of wages in the main outsourcing locations of India, China and Eastern Europe catching up with richer economies. Further technology developments and automation may mean that the costs of transactional processing fall to such an extent that outsourcing no longer has major cost benefits.

Partly as a result of the outsourcing trend, some have argued that organisations are changing such that functions are becoming less important. Cross-disciplinary teams, collaborative networks and the management of processes are emphasised instead. These ways of organising may be effective but there does seem to be a long way to go. Exemplars of such trends make the news because they are different from the norm. Oticon, the so called 'spaghetti organisation', introduced a radical project-based structure in the 1990s and has been the subject of many studies since. Structural innovations at the hearing aid manufacturer included reducing the hierarchical layers to two, project managers negotiating salaries, employees taking on jobs outside of their area of expertise and deciding for themselves which projects to work on. It should be noted that while maintaining its project focus the organisation does seem to have reverted to a more traditional matrix structure.[2]

The majority of organisations still have identifiable functional groups to which resources and goals are allocated. Executive management groups tend to comprise functional heads and many careers develop along functional lines. So the analysis of functional structures remains important – even if it is to draw attention to their ineffectiveness and propose alternatives.

The content of functional roles also has to respond to environmental changes. For example, the role of finance swings between a control focus and a strategic focus in response to economic events and trends. The scandals of Enron and WorldCom increased the focus on control. Periods of economic growth have emphasised the need for strategists and those willing to respond to investor demands for higher leverage. The current economic crisis favours those who resisted such demands and are skilled in managing cash flow to enable organisations to survive. Do some functional structures better support such responsiveness and demonstrate resistance to the excesses of inappropriate management fads and fashions?

WE NEED YOUR INPUT

We have touched on a broad range of organisational issues and welcome your comments on any of the content in the two articles. In particular, we would be interested in your views, experiences and examples in relation to the following questions:

- How and why do the positions and relationships between different functions vary in response to factors such as strategy, national differences, industry and organisational environment?
- How do you assess functional contributions to organisational success?
- How is it feasible to combine business partner and control roles?
- What are the main changes functions face and what will be the impact?
- How do you build appropriate and adaptive functional structures?

Please email me at rick.payne@icaew.com or write to me at the faculty.

BUILDING DESIRED FUNCTIONAL STRUCTURES IS DIFFICULT

Even having conceived appropriate functional structures, which take into account predicted futures as far as possible, organisations still face the challenge of building such structures. This is by no means straightforward despite the ready availability of advice on change management. Much of this advice suggests using staged models and paying attention to key supporting processes. Not surprisingly such models overlap with the earlier discussion of organisational alignment. Organisations are advised to develop (or reconfirm) and communicate a vision and mission from which strategy and objectives then flow. These are supported with appropriate structures, systems and processes. Significant effort is invested in ensuring that the organisation has the necessary culture, people and leadership to ensure success. Measurement is put in place to monitor success and provide a basis for corrective action where necessary. Understanding these rational, planned models is important.

However, it is also important to use the insights that can be obtained from other approaches. A political perspective emphasises the need to build coalitions to ensure support from key players in the change process; this may require compromise and less than optimal solutions. Sir Howard Stringer's change efforts at Sony have been slowed by other executives and he has only recently been able to install 'loyal lieutenants'.[3]

Chaos and complexity perspectives emphasise non-linear cause and effect relationships, the importance of feedback loops and demonstrate how small changes can have major impacts. Conversely, systems may have built in negative feedback loops which draw organisations back to the existing equilibrium despite extensive change efforts. For instance, a firm invests in management information systems in order to standardise reporting and to enable line managers to carry out their own analysis and then lays off the management accountants previously crunching the numbers. Subsequently, line managers, tired of the administrative burden and unable to get the tailored, ad-hoc information they need, hire 'business analysts' to do the work for them.

Interestingly, culture is often seen as something that can easily be manipulated by management, in defined directions and in a short space of time. Yet this is simplistic because culture is difficult to observe and discern and includes consideration of deep seated values, beliefs and ideologies. The reality is that culture changes slowly and does not always respond to management plans in the intended way.

We have argued that there are specific challenges facing organisations in developing appropriate functional structures and ensuring their continued suitability. Your input on any of the points raised in this article and in particular on the questions in the side box on page 7 will be invaluable in developing further insights into how these challenges can be overcome.

REFERENCES

1. Christensen, C.J. (2005), *The Innovator's Dilemma*, Collins, New York.
2. Foss, N.J. (2003), 'Selective Intervention and Internal Hybrids: Interpreting and Learning from the Rise and Decline of the Oticon Spaghetti Organization', *Organization Science,* Vol 14 No. 3.
3. 'Game On', *The Economist*, 5 March 2009.

Rick Payne leads the faculty's *Finance Direction* programme.
rick.payne@icaew.com

GAA
Global Accounting Alliance

The ICAEW is a founder member of the Global Accounting Alliance, which represents over 775,000 professional accountants in over 165 countries worldwide, to promote quality services, share information and collaborate on important international issues.

ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

Because of us, people can do business with confidence.

ICAEW
Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA UK

T +44 (0)20 7920 8466
E financedirection@icaew.com
icaew.com/financedirection

TECPLM9945 02/11