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McKinsey on Finance

Perspectives for CFOs and other finance leaders

Time and consequence

Inside: Tying short-term decisions to long-term strategy, sharpening resource allocation, planning succession, developing AI capabilities, approaching green M&A possibilities, finding the time to be a more effective CFO—and more

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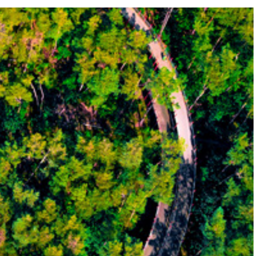

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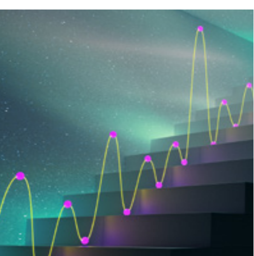

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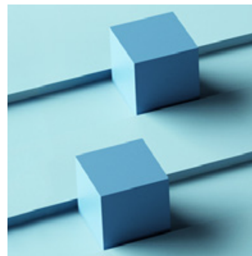

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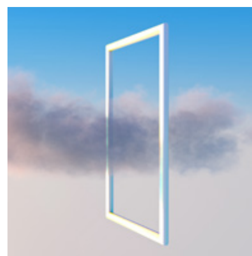

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Item 1: This edition

The road to long-term value creation is paved with immediate actions. It falls to the CFO to drive many of a company's most consequential initiatives.

Positive outcomes start with effective resource allocation and planning, a subject we've been exploring in depth across multiple dimensions. In this edition, we present the findings of our survey of finance leaders from around the world ("Tying short-term decisions to long-term strategy"); their responses suggest that better approaches in four areas—governance, processes, analytics, and decision making—can position companies for better long-term performance. In "Keep calm and allocate capital: Six process improvements," Tim Koller and Zuzanna Kraszewska take a closer look at resource allocation processes and describe steps that CFOs can take to achieve significant improvements.

Another fundamental element of the CFO's mission is to continually improve the financial function's internal capabilities—which, today, means not only deploying more cost-effective digital tools but also developing the personal skills needed to use them. Steven Eklund and his colleagues share their perspective in "Generative AI in finance: Finding the way to faster, deeper insights."

CFOs should also be prepared for environmental risks and opportunities—including by considering M&A. In an excerpt of "Creating value from green M&A," we share a decision framework from McKinsey M&A coleader Mieke Van Oostende, Nikolaus Raberger, and their coauthors for approaching sustainability dealmaking in a value-creating way.

Seasoned financial leaders know that they shouldn't expect shortcuts to sustaining a high valuation. In "The myth of an enduring index premium," we find that while being included in (or excluded from) a major index does tend to change the stock price temporarily, the effect disappears in a few weeks. The market understands that there's no substitute for long-term value creation.

Yet given the always intense and at times competing demands of leading today's finance function, CFOs might wonder how it's possible to find the *time* to successfully deliver all that their role requires. In fact, it's one of the questions we're asked the most. Colleagues Ankur Agrawal, Matthew Maloney, Meagan Hill, and Abhishek Shirali address the challenge in "Six ways CFOs find the time to unlock their full potential." And Marjorie Lao—who served as the CFO of the LEGO Group and, before that, as the CFO of the Norway-based public company Tandberg (now part of Cisco Systems) and is now a director on multiple boards—shares some of her most important insights with Christian Grube on how CFOs can think strategically, and tactically, to improve the finance function, better serve a range of stakeholders, and create more value for the long term. We also examine ways to better identify and develop successors in this edition's *Bias Busters* section, "Next in line? A structured approach to succession planning."

Finally, in our closing section "Looking back," we explore company performance after shareholder activists exit their positions. As our colleagues show, near-term stock price changes are no guarantee of long-term success. The consequences of short-term decisions become clear only over time.

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Tying short-term decisions to long-term strategy

A new survey confirms the well-founded principles behind the allocation of resources for long-term value creation.

by Andy West and Tim Koller
with Rishabh Bhargava

For years, we've pointed to best—and worst—practices in resource allocation.[1] To maximize cash flow over the long term, organizations need to shake free from an incremental approach and shift resources now to invest where the growth will be. Studies show that companies that actively reallocate resources outperform those that don't.[2] Yet making bold moves is a lot harder than it sounds. Inertia inevitably takes hold in most organizations. Leaders default to allocating resources in the same old ways, failing to champion growth; teams get lost in the details rather than highlighting the few most important sources of value creation; and even the most brilliant executives fall prey to common decision biases—which become magnified in an organizational setting.

Our latest survey strongly confirms these long-held observations about resource allocation and identifies some practices that can help leaders address them: too many companies do not effectively follow through on their strategies, thereby hindering their chances of outperforming competitors in the long run.

In our new McKinsey Global Survey on resource allocation, we find that only about half of the 617 executives and managers surveyed say their companies effectively align their budgets with their corporate strategies.[3] What's more, just 53 percent say their organizations are in the habit of fully funding the priorities they've identified. Respondents report that their organizations are not taking enough risk with their investments, suggesting that leaders may not be sufficiently planning for the long term. Yet those who indicate that their organizations succeed at linking their budgets to their corporate strategies—and at taking appropriate levels of risk—are much more likely than others to report that their organizations outperform on both revenue growth and return on capital.

In particular, the survey results suggest that better approaches in four areas—governance, processes, analytics, and decision making—can position companies for better long-term performance.

Governance: The importance of influential and involved leadership

In our experience, effective governance can make or break a company's ability to achieve its strategic goals. The impact is most significant when the CEO is supported by a strong financial-planning and -analysis (FP&A) or corporate strategy team.[4]

However, a previous survey of strategy leaders found that only about one-quarter reported having a clear mandate aligned with the rest of the company, and many struggled to enhance their companies' performance.[5] Our latest research reinforces the significance of having an influential FP&A or corporate strategy leader, as well as senior managers who actively participate in carrying out corporate strategies.

Respondents who say that the leader of the team responsible for developing the organization's three- to seven-year financial plan holds influence—meaning they have significant influence on C-suite leaders and throughout the organization—are much more likely than their peers to say their organizations outperform their competitors. Those who say that this leader, who is typically from the FP&A or corporate strategy team, has significant influence on the CEO's and CFO's thinking on strategy and

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[1] Aaron De Smet and Tim Koller, "Capital allocation starts with governance—and should be led by the CEO," McKinsey, June 22, 2023.
[2] Marc de Jong, Nathan Marston, and Erik Roth, "The eight essentials of innovation," *McKinsey Quarterly*, April 1, 2015; see also Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 1, 2012.
[3] The online survey was in the field from October 3 to October 13, 2023, and garnered responses from 617 participants representing the full range of regions, industries, and functional specialties. The survey included only respondents working in midlevel-manager, senior-manager, and C-level positions at companies with reported revenues of $500 million or more. To adjust for differences in response rates, the data are weighted based on each respondent's nation, taking into consideration its contribution to the region's share of the global GDP. Just over half of the respondents say that their companies often or consistently transform strategic goals into three- to seven-year strategic financial plans. A similar share say their organizations' annual budgets are aligned with their strategic financial plans, and we know from experience that, at many companies, the previous year's budget drives decisions for the following year.
[4] "Capital allocation starts with governance," June 22, 2023.
[5] The 2022 McKinsey survey on the role of the strategy leader surveyed more than 300 strategy leaders. Forty-two percent of respondents said they were not fully successful at improving company performance.

resource allocation are 1.8 times more likely than those who deny such influence to report that their organizations outperform on revenue growth, and they are 1.9 times more likely to report that their organizations outperform on return on capital (Exhibit 1). Similarly, respondents who agree that the leader is highly influential throughout the organization are 1.4 times more likely than those who disagree to say their organizations outperform on revenue growth and 1.7 times more likely to say their organizations outperform on return on capital. Overall, 51 percent of respondents report that this leader is highly influential across their organization.

The leadership's level of involvement within an organization also matters. Respondents who say that their corporate senior management often or almost always gives clear strategic direction to business units and product lines are more likely than others to report financial outperformance.

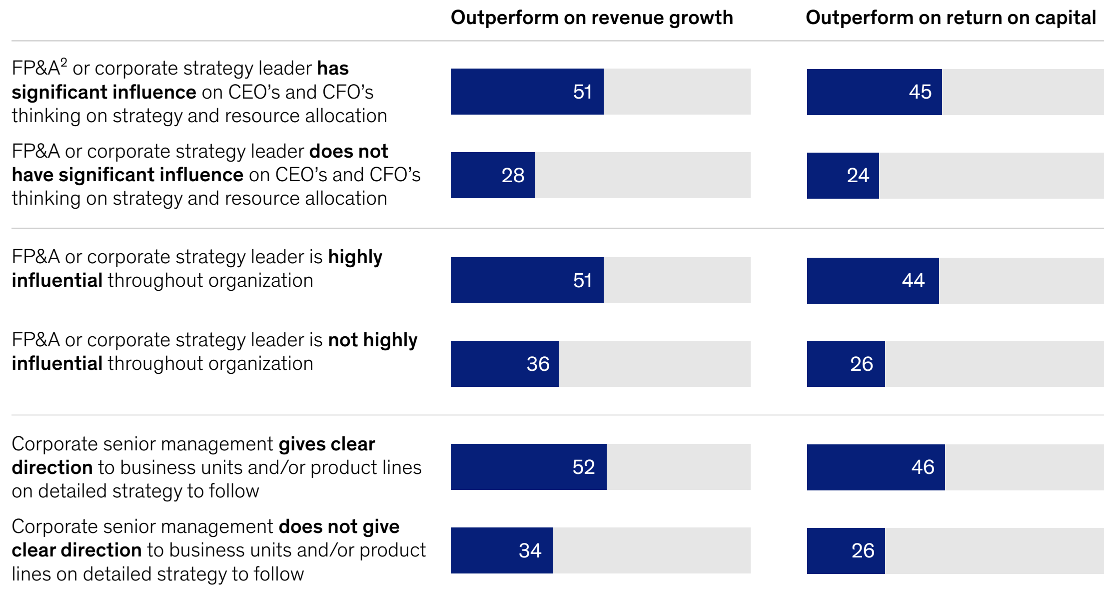
Processes: The nimbler, the better

Companies often move slowly to create plans and reallocate resources, with prolonged timelines for financial planning that can diminish the process's value. Nearly half of respondents say it usually takes their organizations at least four months to develop and approve their three- to seven-year strategic financial plans, and one-third say it takes at least four months to finalize their organizations' annual budgets. The survey results suggest that the shorter the process, the better. Respondents who say their organizations develop and approve their three- to seven-year strategic financial plans in three months or less are more likely than others to say their

Exhibit 1

Respondents reporting influential, involved FP&A or strategy leaders are much more likely than others to say their organizations outperform.

Respondents who agree that their organizations outperform competitors, by each of the following statements,[1] %



[1]Respondents who answered "disagree," "neutral," or "don't know/not applicable" are not shown.
[2]Financial planning and analysis.
Source: McKinsey Global Survey on resource allocation; 617 midlevel managers through C-level executives at organizations with $500 million or more in reported annual revenues; Oct 3–13, 2023

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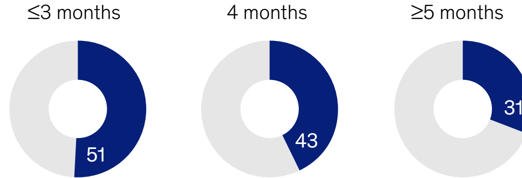
Exhibit 2

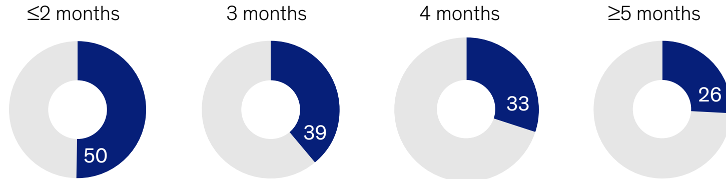
Respondents reporting faster development of strategic financial plans and annual budgets are likelier than others to say their organizations outperform.

Respondents who agree that their organizations outperform competitors on return on capital,[1] %

Reported time spent developing organization's 3- to 7-year strategic financial plan



Reported time spent developing organization's annual budget



[1]Respondents who answered "disagree," "neutral," or "don't know/not applicable" about their organizations' return-on-capital performance are not shown.
Source: McKinsey Global Survey on resource allocation; 617 midlevel managers through C-level executives at organizations with $500 million or more in reported annual revenues; Oct 3–13, 2023

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organizations outperform on revenue growth and return on capital, and the same is true of respondents who say their organizations create and approve their annual budgets in two months or less (Exhibit 2).

What's more, survey responses link nimble reallocation of resources with self-reported financial outperformance.[6] Respondents who report that their organizations reallocate resources across business units within the year are much more likely than respondents who report no in-year reallocation to say their organizations outperform on both revenue growth and return on capital. Additionally, when respondents say that their organizations incentivize executives to free up resources for higher-value-creating opportunities elsewhere in the enterprise, they are 1.8 times more likely than others to report outperformance on revenue growth and 1.7 times more likely to report outperformance on return on capital.

Analytics: Rigorous financial analysis of projects is mandatory

Organizations that use rigorous, standardized analytics to assess initiatives' performance and their potential to create value can ensure consistent evaluation across different parts of the business, which can help them effectively prioritize strategic initiatives. Respondents who say most or all of their organizations' projects are evaluated using financial metrics (such as net present value or internal rate of return) are much more likely than those who say half or fewer projects use those metrics to report that their organizations outperform on revenue growth and return on capital. The survey results also suggest that the acknowledgment of uncertainty in forecasts matters. Respondents who say their organizations' financial forecasts for all projects include a range of outcomes are 1.7 times more likely than those who don't to say their organizations outperform on both revenue growth and return on capital.

[6] For more about in-year flexibility with allocation and other processes for effectively allocating capital, see Tim Koller and Zuzanna Kraszewska, "Keep calm and allocate capital: Six process improvements," McKinsey, June 5, 2024, on page 11.

The findings also suggest that ranking strategic programs based on financial outcomes can help guide effective resourcing decisions—but only if companies do so consistently (Exhibit 3). Just 28 percent of all respondents say that their organizations almost always rank their top ten to 30 most important strategic programs based on financial metrics, but those who report that frequency are much more likely than those who say they do so "sometimes" or even less frequently to report that their organizations outperform on revenue growth and return on capital.

Decision making: Debias to pursue bold investments

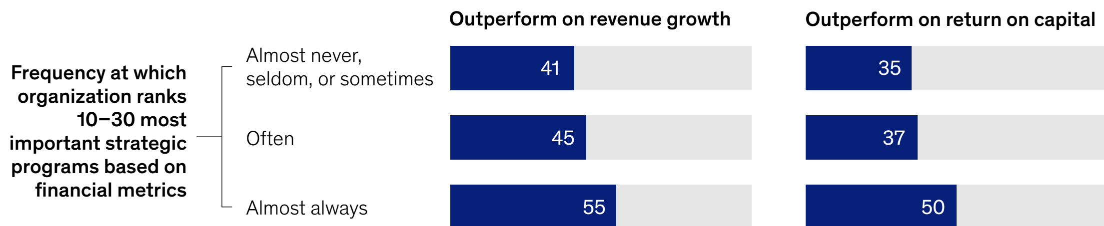
Human nature is remarkable. It makes innovation possible—along with a multitude of invaluable advancements (not least in healthcare, agriculture, and standard of living) that benefit billions of people. But human nature is prone to biases, which can impede innovation itself, particularly in a corporate, organizational setting. One such bias is striving to achieve consensus across a large number of executives, which can stifle debate and hinder strategic-planning decisions. If not addressed, groupthink and loss aversion—the tendency to experience losses more acutely than gains—can easily prevent companies from making bold investments in initiatives that have the potential to create more value than lower-risk investments. Breaking out of this groupthink starts at the top, and several management practices that help companies do so are ones that survey responses commonly link with outperformance.

Our survey results support previous research that suggests the importance of rigorous debate, particularly as a predictor of success in making "big bet" decisions.[7] In the latest survey, respondents who say their organizations' critical resource allocation decisions are often or almost always preceded by the management team engaging in active debate are 1.3 times more likely than others to say their organizations outperform on revenue growth and 1.4 times more likely to report outperformance on return on capital (Exhibit 4). Furthermore, when respondents say C-suite and division leaders at their organizations often or almost always discuss multiple outcomes, including unfavorable ones, they are 1.7 times more likely than others to say their organizations outperform on revenue growth and

Exhibit 3

Ranking strategic programs based on financial outcomes can help guide effective resourcing decisions—if companies do it consistently.

Respondents who agree that their organizations outperform competitors,[1] by extent to which organization ranks strategic programs, %



[1]Respondents who answered "disagree," "neutral," or "don't know/not applicable" are not shown.
Source: McKinsey Global Survey on resource allocation; 617 midlevel managers through C-level executives at organizations with $500 million or more in reported annual revenues; Oct 3–13, 2023

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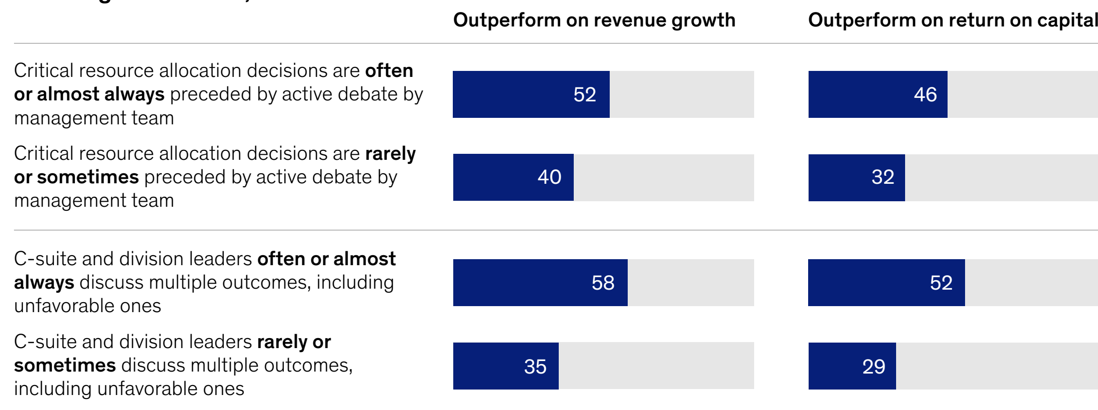
[7] "Decision making in the age of urgency," McKinsey, April 30, 2019.

Exhibit 4

Respondents reporting rigorous debate and consideration of multiple outcomes as norms are more likely to say their organizations outperform.

Respondents who agree that their organizations outperform competitors,[1] by each of the following statements, %



[1]Respondents who answered "disagree," "neutral," or "don't know/not applicable" are not shown.
Source: McKinsey Global Survey on resource allocation; 617 midlevel managers through C-level executives at organizations with $500 million or more in reported annual revenues; Oct 3–13, 2023

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1.8 times more likely to report outperformance on return on capital.

Employees at any level of an organization sometimes hesitate to speak up in meetings, particularly if they disagree with a senior leader. But there is a body of research that suggests that decision making is more effective when more voices are included. Respondents who say executives at all levels are often or almost always comfortable disagreeing with their leaders are 1.8 times more likely than others to report outperformance on revenue growth and 1.6 times more likely to report outperformance on return on capital. The importance of this comfort seems to extend beyond just executives: respondents who say their organizations' employees are comfortable expressing contrarian points of view to senior colleagues are nearly twice as likely as others to report outperformance on revenue growth and return on capital.

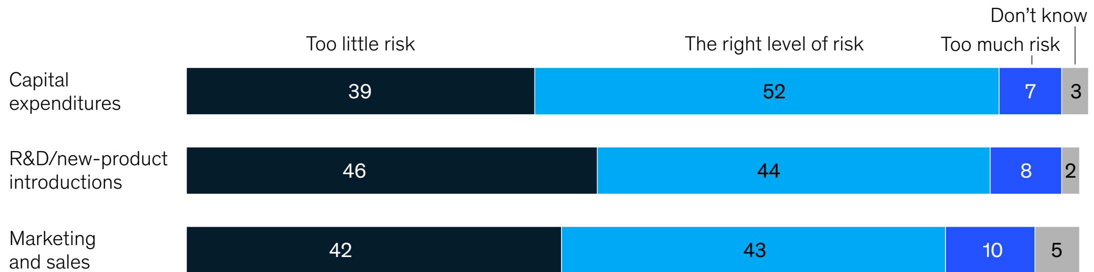
The results also suggest that overcoming loss aversion, a common decision-making bias, serves companies well. To overcome loss aversion, some companies reward noble failures—that is, courageous, responsible, and well-executed initiatives that don't ultimately achieve their goals but can provide valuable lessons. Taking on what respondents deem "the right level of risk" with a company's portfolio and investing for the long term are correlated with self-reported outperformance. Strikingly, though, the share of respondents who say their organizations take too little risk in certain areas is nearly as large or larger than the share saying their organizations pursue the right level of risk (Exhibit 5).

Respondents who indicate that their organizations take on appropriate risk with capital expenditures are 1.6 times more likely than those reporting too little risk to say their organizations outperform on revenue growth and 1.6 times more likely than others to say their organizations outperform on return on capital. What's more, the more often respondents say their organizations invest in low-probability, high-payoff projects within R&D and marketing and sales, the more likely they are to say their organizations outperform on revenue growth and return on capital.

Exhibit 5

Respondents often say that their organizations are taking too little risk with their investments.

Level of reported risk that respondents' organizations take in given category,[1]
% of respondents



[1]Figures may not sum to 100%, because of rounding.
Source: McKinsey Global Survey on resource allocation; 617 midlevel managers through C-level executives at organizations with $500 million or more in reported annual revenues; Oct 3–13, 2023

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While there are also well-established benefits to encouraging individuals to take risks, just 28 percent of respondents say top management at their organizations encourages high-potential, risky projects. Respondents who say that their management does support employees in taking on these efforts are also more likely than others to report outperformance, both on revenue growth and return on capital.

Lessons for today—and the long term

The findings suggest that organizations that take a long-term approach are turning strategy into value more effectively. Organizations that respondents say prioritize long-term value creation over short-term profits are much more likely than their peers to effectively translate strategic goals into a strategic plan and budget. They are also almost two times more likely to outperform competitors on growth and return on capital than organizations that respondents say do not prioritize the long term. We see a similar connection between innovation and effectively executing strategy: for example, respondents who agree that their organizations are more innovative than competitors are twice as likely as those who disagree to say their organizations effectively translate strategic goals into their three- to seven-year strategic financial plans.

Companies can't stand still; innovation and creative destruction are always on the march. The most spectacular growth stories are those made possible by unshakable commitments to bold resource allocations over long time horizons. As technology races forward and the future seems even more unpredictable, today's leaders are reaffirming what's been fundamental for years—and strikingly so, as our survey finds.

The survey content and analysis were developed by **Andy West** (Andy_West@McKinsey.com), a senior partner in McKinsey's Boston office; **Tim Koller** (Tim_Koller@McKinsey.com), a partner in the Denver office; and **Rishabh Bhargava** (Rishabh_Bhargava@McKinsey.com), a consultant in the New York office.

They wish to thank Derek Schatz and Zev Mayer for their contributions to this research.

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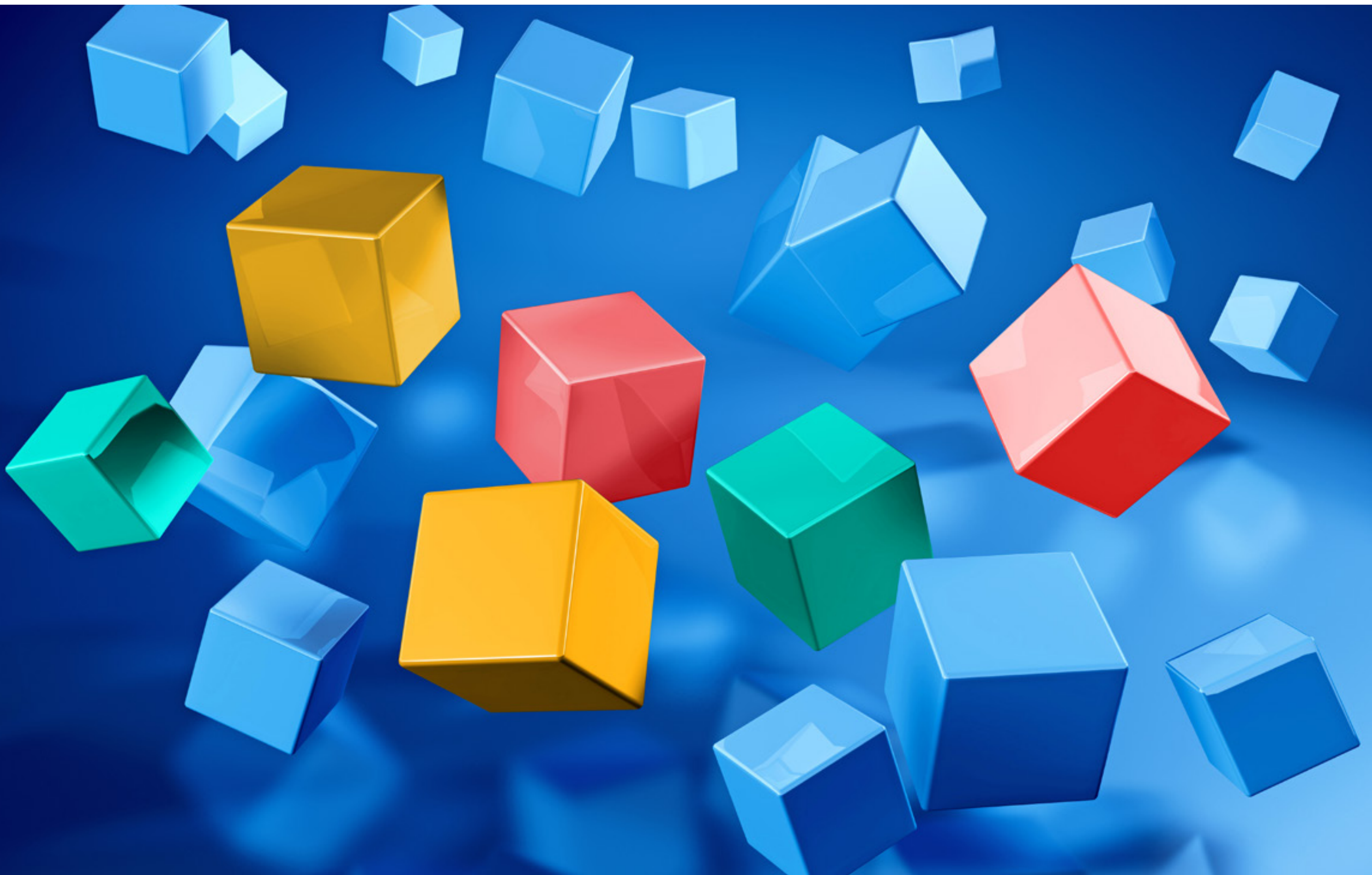
Keep calm and allocate capital: Six process improvements

The most effective resource allocation processes are radically simple.

by Tim Koller
with Zuzanna Kraszewska



Most large corporations have annual processes to allocate capital and other resources across business units and for strategic initiatives enterprise-wide. The typical practice is to begin with a strategy or "strategic refresh," develop a long-term (three- to seven-year) financial plan, and lay out a highly detailed budget for the first year of the plan. Unfortunately, the processes are often both muddled and rigid; they typically take months to iterate, generate reams of distracting detail, and then fail to allow for sufficient flexibility to adjust resource allocation over the year. The result: a failure to align resources with strategy.

Every company faces unique challenges. Not all of the measures we describe in this article will be appropriate in every situation, and there's no one-size-fits-all list of process improvements. However, we find that in most cases, senior leaders should do the following:

— As part of the strategy or strategic refresh, identify the role of each business in realizing the company's strategy (for example, to accelerate growth, improve ROIC, or divest) and the company's ten to 30 most important initiatives.

— Use a streamlined approach to develop the company's long-term financial plan by employing a value driver model, with only a few line items for each individual business unit or product line.

— Ensure that the long-term financial plan allocates resources to the company's ten to 30 most important initiatives.

— Match next year's budget to the first year of the long-term financial plan.

— Keep to a compact planning schedule.

— Design in-year flexibility, at a regular cadence, to allocate more (or less) resources to existing or new initiatives.

In this article, which is part of our ongoing "Strategy to action" to help companies improve resource allocation, we explain each of these six critical process improvements.

1. Identify each business unit's role and the most important enterprise initiatives

Every strategic refresh should address two fundamental questions: first, what is the *role* of each business in realizing company strategy (such as to accelerate growth, improve ROIC, or divest), and second, which *specific initiatives* are the highest priority for the company, within that business and across the enterprise? In our experience, we have found that the sweet spot for companies is ten to 30 essential initiatives. If the list is longer than that, it can diffuse attention and become impractical to manage. If it's shorter, it probably misses some important initiatives that top management should be involved with.

For example, a company may announce that its strategy is to grow in Latin America. That may be a terrific idea, but without more detail it isn't actionable. Resources can't be allocated to catchphrases. What would a practical Latin America growth strategy look like? To start, the company should identify the specific countries it will focus on. Next, it should spell out the major considerations, such as whether the company intends to enter a country on its own (perhaps using a team in a country relatively near where it already has a presence), partner with an existing player in that market, or make an acquisition. The company should also allocate the capital needed for whichever of those options (or others) it intends to pursue. Nor is money enough. The company should identify which business or team will be accountable, name a full-time team leader, be clear about which steps are needed (for example, identifying targets and building relationships), and make sure that the initiative is not starved of money or senior-management attention.

2. Focus on a small number of key value drivers for the long-term financial plan

Most companies' long-term financial plans include too many line items. This kind of detail slows down the process, makes iteration difficult, and can obscure the true drivers of value.

To be effective, a long-term financial plan needs to be concise. For example, there is no need for ten or more items under general and administrative (G&A) expenses; the G&A line can stand alone. In most cases, income statements for each business should include only revenues, cost of goods sold, sales and marketing, R&D, and overhead costs—without disaggregating detail. An enterprise runs on value drivers, not accounting items. An effective financial plan clearly lays out the most important value drivers for each business unit, surfacing the few key elements that are most important for profitable growth, return on capital, and other company imperatives.

What do key value drivers look like? Consider a filmmaking company: there is a lot that goes into creating successful movies over a multiyear period. But cut to the chase (as they say in Hollywood), and its model can be simplified to producing three blockbusters and five smaller films. Its most impactful value drivers are the average budgets for large and small films, marketing costs, and overhead expenses. A music subscription business, for its part, would have similarly compact but completely different key drivers: the number of subscribers, revenue per customer, and customer churn.

In our experience, many senior leaders push back on "keep it simple," saying that it is impossible to distill their businesses into just a few drivers. But these leaders are mistaking the forest for the trees—and underestimating the costs of examining too many trees. It isn't possible to achieve 100 percent certainty in a complex business; regardless of industry, a competitive landscape is constantly shifting and usually can't be predicted to a few percentage points. Parsing excessive line items, meanwhile, takes away time that could be better spent managing issues that have more of an impact, and yields diminishing returns. Often, the extra detail delivers no benefits at all.

While the number of line items should be kept to a minimum, the number of business units or product lines should be sufficiently granular to aid the allocation of resources based on the roles, objectives, and needs of each business unit. For example, a

Many senior leaders push back on 'keep it simple,' saying that it is impossible to distill their businesses into just a few drivers. But these leaders are mistaking the forest for the trees—and underestimating the costs of examining too many trees.

division with a fast-growing business unit and a mature or shrinking business should be divided into two businesses, so that top management can ensure that each has the right goals and resources (even if the division leader remains responsible for execution). In practice, a large corporation's long-range financial plan should typically cover 20 to 50 product lines or business units.

3. Ensure that resources are allocated to the most important priorities

We've been surveying senior leaders for years, and a majority of them report that their organizations are underinvesting. Digging deeper, this usually means that companies don't allocate the proper resources to the most important strategic initiatives, especially growth initiatives. Often, the long-range financial plan simply states the targets and financial projections for each business unit.

A better approach is to be clear on targets *and* have the long-range financial plan highlight the specific resources that are allocated to the highest-priority initiatives, whether they are enterprise-wide or within a particular business unit, to make sure those targets are met. This typically requires the company to allocate resources among its business units differently from how it had in prior years, regardless of legacy spending or "fairness."

For example, one major consumer-packaged-goods company took away the "base" level of spending for some of its legacy European operations because of their lack of growth and relatively low returns on capital. Instead, the company allocated those resources to three specific initiatives in Latin America. And at one leading retailer, the CEO personally ensures the full funding and management of the company's top six enterprise initiatives, in addition to spending almost one day per week on those initiatives.

4. Base this year's budget on the first year of the long-term financial plan

Remarkably, the prolonged financial-planning process usually ends with a year one budget that does not tie to the long-range financial plan; instead, the year one budget is often closer to the last year's budget. In a McKinsey survey of over 1,200 executives, less than one-third of participants reported that their company's budgets were similar or very similar to their most recent strategic plans.[1] Another study revealed a striking 90 percent correlation in investment spending from year to year.[2] While some degree of year-to-year correlation is to be expected, it's clearly impossible for a company to boldly reallocate capital (an approach that our research shows creates the most value for companies on the whole) when it keeps allocating capital to essentially the exact same things.

While the year one budget should be more detailed than the long-term financial plan, the top-line revenues, profits, and cash flows for each unit should always match year one of the long-term plan. Two techniques are useful for making this happen. First, start building the budget based on the initial year of the financial plan, rather than on last year's budget or current year's results. Second, require that only the CEO and CFO have authority to approve deviations from the long-range plan. Without that rigor, resource allocation tends to dissipate in a cloud of uncertainty.

5. Compress the time frame for the entire planning process

Financial planning can be a never-ending story. A senior team starts with a strategic refresh in the first quarter, followed by a long-term financial plan that kicks off in the second quarter, and finishes toward the end of the third quarter. Meanwhile, the budget for the next year begins in the third quarter and wraps up at the turn of the year—or even later.

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[1] "The finer points of linking resource allocation to value creation," McKinsey, March 29, 2017.
[2] Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, New York, NY: John Wiley & Sons, 2020.

This prolonged timeline invites unnecessary draft turning and complexity, and diminishes the forcing-mechanism value of having to make a decision on the most important initiatives and value drivers.

The resource allocation process should be synchronized and as short as possible, with each step taking a maximum of two months. These steps should be scheduled as late in the year as possible, while still allowing ample time for rigorous analysis and meaningful debate. The entire process should also be contiguous.

One consumer retail company's process serves as an example of an *inefficient* resource allocation timeline. The company conducts its annual strategic refresh in April or May, followed by long-term financial planning in September and October. Finally, after about two more months of hiatus, the budgeting process takes place from December until March for the calendar year that has already begun. Each step in the process is excessively time-consuming and remarkably disconnected from one another. A consumer-packaged-goods company, by contrast, demonstrates a more effective resource allocation timeline. The company initiates its annual strategic refresh in May, which drives the long-term strategic financial plan and resource allocation process conducted from June until September. The long-term strategic financial plan flows into the annual budgeting process, which starts in October and ends in November.

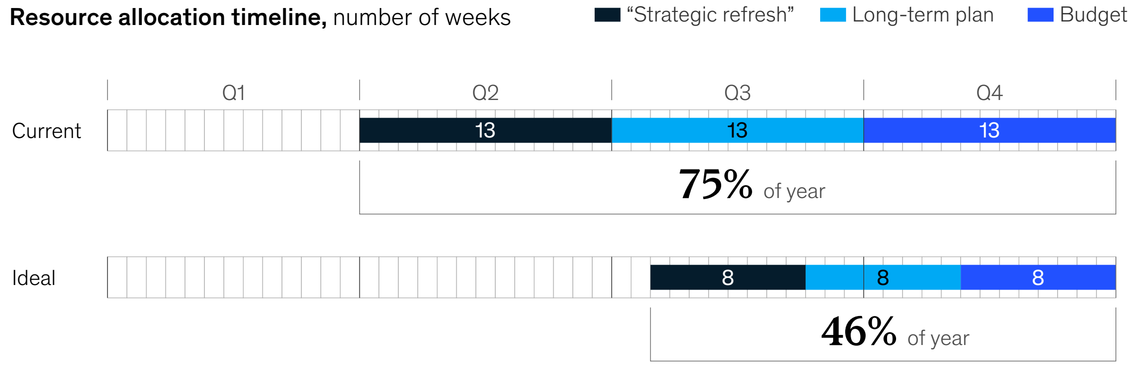
A process that runs from May to November is better than one that runs all year long and into the next, but it can still be significantly improved. First, any gaps in the processes should be eliminated; the longer plans sit, the more stale and less urgent they become. Second, decision makers should realize that multiple iterations are a tax on their time—they should receive one or two bites of the apple, and put in the work up front to make sure there aren't excessive numbers of drafts. Finally, the second quarter is simply too soon to start; it provides an unnecessary cushion, at the expense of harder deadlines and greater focus.

Precise timelines will vary depending on the enterprise—which in turn depends on its industry (technology companies, for example, move much faster). But to borrow from the old saying, nothing so concentrates the mind as 24 weeks to finish a strategic refresh, a long-term financial plan, and year one of next year's budget. In most cases, a company should begin its strategic refresh shortly after midyear and complete the refresh before the end of the third quarter; immediately commence its long-term strategic financial plan once the refresh is completed; and then, when the long-term strategic plan is done, immediately turn to its budget for the upcoming year. For a company whose fiscal year matches the calendar year, the process would begin after midyear and finish in mid-December (exhibit). Across industries, CFOs of companies that have more compact timelines

Nothing so concentrates the mind as 24 weeks to finish a strategic refresh, a long-term financial plan, and year one of next year's budget.

Exhibit

Companies can aspire to a much faster and more compact resource allocation timeline.



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report that they outperform their peers on numerous dimensions.[3]

6. Build in year-round resource allocation

Budgets are never perfect—which is exactly what one would expect, since circumstances change over the course of the year. For many companies, the approach to in-year flexibility is to allocate the resources to each division or unit leader and give them the decision rights to reallocate among lines they control, as they see fit. This, however, creates a perverse incentive for divisions or business units to hoard resources they don't need, spend it on lower-priority items or, even worse, underinvest in strategic initiatives to meet short-term targets.

To prepare for inevitable changes in the number of resources needed and available during the year, the authority for meaningful flexibility in resource allocation should belong only to senior leaders, at the enterprise level. An investment committee, including the CEO and CFO (and ideally only one to three additional voting members, with the CEO making the deciding call) should meet monthly to make important in-year investment decisions.[4] These monthly meetings should be for *decisions*, not for progress updates or general reviews. The agenda should address only those matters that require a decision—and the result should never be "deciding to decide." Key decisions that the committee may make during these meetings can involve allocating funds for stage-gated projects or projects that were provisionally approved during the annual planning process, discontinuing projects that aren't likely to meet their objectives, and approving new projects that arose after the annual planning cycle.

Flexibility usually requires setting a reserve of unallocated funds that can be used during the year for new initiatives that were not anticipated during the planning process. Withdrawals from the reserve should be authorized only by the CEO or investment

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[3] For more on the benefits of nimbler resource allocation processes, see the McKinsey Global Survey, "Tying short-term decisions to long-term strategy," McKinsey, May 20, 2024, on page 4.
[4] For more on the governance of capital allocation, see Aaron De Smet and Tim Koller, "Capital allocation starts with governance—and should be led by the CEO," McKinsey, June 22, 2023.

committee and must align with well-defined criteria, such as affirming that the release is for a strategically vital initiative or covering essential external costs, such as dealing with natural disasters. While there is no universally applicable percentage for the “right” amount to reserve, a general guideline is to set aside 5 to 20 percent of the corporation’s budget. For businesses operating in sectors with longer project lead times and minimal market volatility, such as utilities, a strategic reserve of about 5 percent of the budget may be sufficient. Conversely, industries characterized by rapid market changes and fluid resource allocation, like software, may find a reserve of approximately 20 percent more appropriate. Consumer-packaged-goods companies, for example, may encounter a newly launched campaign that fails to meet its targets or a competitor that launches a new product that senior leaders did not anticipate. As situations arise, the investment committee should reallocate resources quickly, opening up opportunities for other businesses and initiatives throughout the year.

Certain projects are easier to stage-gate during the formal planning cycle, such as pharmaceutical companies preparing to make significant investments in marketing once regulatory approvals are obtained. Other allocations of capital may be approved only provisionally because they require further analysis (for example, proof of concept for a new technology, or decisions to drill to a gas or petroleum deposit); in those cases, the investment committee should withhold that capital for in-year allocation. The key is to build in flexibility. An effective resource allocation process anticipates change and maintains at least a monthly cadence—and ideally, one that is more frequent than that.

The processes for turning strategy into action should be radically simple. The most effective processes clearly spell out the strategy and the role of each business in achieving that strategy, identify the most important value drivers, ensure that the most important initiatives have the resources they need, insist that the budget matches the first year of the long-term financial plan, keep to a compact planning schedule, and design and demonstrate in-year flexibility. After all, managing a large corporation is already complicated enough.

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Generative AI in finance: Finding the way to faster, deeper insights

Generative AI technologies can automate time-consuming tasks for finance professionals, but can they be trusted to give the right answers?

This article is a collaborative effort by Steve Eklund, Andrii Kurdiuk, Avani Kaushik, Edward Woodcock, Jan Svoboda, and Lisa Kaufman, representing views from McKinsey's Operations Practice.

Business leaders are excited about generative AI (gen AI) and its potential to increase the efficiency and effectiveness of corporate functions such as finance. A May 2023 survey of around 75 CFOs at large organizations found that almost a quarter (22 percent) were actively investigating uses for gen AI within finance, while another 4 percent were pursuing pilots of the technology.

That enthusiasm has been tempered by concerns over safety, privacy, accuracy, copyright, and social manipulation. In the case of finance, where numerical data and the accuracy of mathematical operations are fundamental, there is also concern over the possibility that gen AI systems could produce inaccurate or misleading information, a phenomenon known as "hallucination."

Developing a finance assistant using generative AI

One European consumer goods company recently developed a proof-of-concept gen AI assistant for finance professionals and business users. The new tool was built in about six weeks by a team of data scientists, engineers, and finance experts. It allows users to ask questions about financial performance in everyday language and rapidly receive answers that aid them in understanding and interpreting the data.

This proof-of-concept exercise was only the company's first step in applying gen AI in the finance function, but it offers several useful lessons for organizations seeking to capture the benefits of these technologies while managing the risks.

1. Start with high-impact, internally facing use cases

Gen AI pilot projects should solve meaningful problems for the organization without creating new ones. That requires a high degree of control over the data that will feed into the model and a design that minimizes security challenges or the potential for data misuse. In this case, the company chose a single in-house dataset and a user group that was already familiar with it.

The proof of concept was designed to address a key pain point for the business. Finance analysts were often overloaded with requests for information from managers, and the managers were frustrated that

Taking advantage of existing IT and digital infrastructure may shorten development time and can also ensure that gen AI solutions integrate existing workflows.

it could take several days to get answers to relatively straightforward questions. Solving that problem helped to create interest in, and enthusiasm for, gen AI technology (Exhibit 1).

2. Assemble the right tools and capabilities for the job

A diverse array of gen AI solutions is available, ranging from on-premises options to cloud-based solutions, and the choice of deployment should reflect the data sensitivity and specific requirements of the use case. Taking advantage of existing IT and digital infrastructure may shorten development time and can also ensure that gen AI solutions integrate existing workflows with minimal disruption.

After aligning on its preferred technology stack, the company assembled a highly integrated cross-functional team to drive the development process. In addition to data scientists and IT engineers, that team included senior members of the finance team, who helped shape the design and acted as superusers during the development and testing phases. Their input was critical to ensure that the new tool met the organization's quality, reliability, and usability requirements.

3. Put humans in the loop, and keep them there

The company also paid significant attention to design of the user interface, maintaining a consistent structure and "look and feel" to provide a straight-

Exhibit 1

The gen AI finance assistant helps users interrogate financial data with speed and precision.

Illustrative examples

Gen AI SG&A[1] copilot

What is the total opex by country for 2021 in Region 1?

The total opex by country for 2021 in Region 1 is the following:

Total opex by country, Region 1, 2021

Total opex, €

A B C D

Country

View explanation

Source: Finance data

Send a message…

Gen AI SG&A copilot

What are the total cost element drivers in Country A for 2021?

The total cost element drivers in Country A for 2021 are the following:

Total cost element drivers, Country A, 2021

Total opex, €

1 2 3 4 5 6

Cost element driver

View explanation

Source: Finance data

Send a message…

[1]Sales, general, and administrative.

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forward and streamlined user experience. One early request from users was for the ability to drill down rapidly through finance data to get to the information they needed. To facilitate this, the tool offers instant graphical visualization of results, so staff can quickly absorb and interpret its answers. All data is also made available in a tabular format that can be shared with other analytical tools.

During development, the company recruited a group of superusers from its finance function as product testers. They were encouraged to apply the tool in real-world situations and to assess and provide feedback on its reliability and usability.

Everyday users also play a central role in the model's quality assurance and risk management. Up front, they are given clear guidance about the types of questions they can ask and how to formulate them. Additionally, to make it easier to check and validate outputs, the model is designed to generate a plain-language explanation of the calculations underlying each set of results it produces.

4. Play to the strengths of gen AI

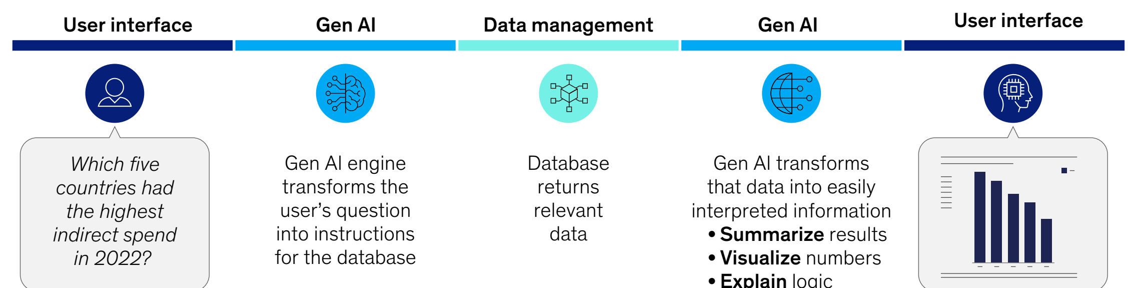
While gen AI is a powerful solution for many tasks, other technologies may be a better fit for some elements of the overall solution. By designing solutions that move functions that can be handled independently of gen AI to other technologies, organizations can enhance the stability and performance of the tools they build.

One limitation of the large language models (LLMs) that underpin many modern gen AI systems is innumeracy. These systems were designed to operate on natural language, not to perform precise calculations, and have been observed to struggle with mathematical computations. Engineering teams are working hard to address this limitation. One approach is to build a hybrid model, using the LLM in ways that build on its strengths and other data tools to perform mathematical manipulations. For its proof of concept, the company used the gen AI system to translate user requests into database queries, then gave the calculation work to a dedicated data analytics platform (Exhibit 2). The output from

Exhibit 2

The generative AI platform provides the interface to financial data but does not perform underlying calculations.

Illustrative example



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the analytics system is passed back to the AI platform, which uses that data to produce several end products, including a text precis of the results, a summary of the calculation methodology, and the computer code used to create the graphical visualization.

5. Optimize the prompts

The team behind the AI assistant also took great care to minimize the opportunity for error and hallucination by engineering the prompts used to trigger the gen AI system. Shorter, simpler prompts encourage large language models to produce more predictable results. They are more efficient, too, since the computational workload of a gen AI system is closely related to the number of language "tokens" it handles in each interaction. For the finance assistant, the team divided the work into three distinct interactions, each handled separately by the gen AI model: translate the user's question into a data query, generate a summary and explanation, and create a visualization.

The company developed examples of effective prompts for interacting with the system plus guidance and training materials to help users generate their own. Those training materials were another chance to emphasize the importance of the human in the loop, reminding users of their responsibility to check the assumptions in the language of their queries and behind the results of every interaction.

6. Build a robust test environment

Fine tuning a gen AI model is a highly iterative process. The ability to test and validate rapidly is key to successful development. To achieve it, the team built a comprehensive automated test suite, which operated using a list of high-priority queries provided by senior finance analysts. This test was run after every update of the model during development, with the results used for further refinement and operation.

7. Put effective governance systems in place

As companies move from pilot projects to mainstream adoption of gen AI tools, they will need appropriate governance frameworks to maintain quality and manage risks at scale. These might include ongoing monitoring and auditing mechanisms to assess AI system behavior, ensuring it aligns with established ethical guidelines. Cross-functional teams of AI experts, ethicists, and legal advisers should evaluate AI models and applications for potential biases or ethical concerns. After the success of its finance assistant proof of concept, the consumer goods company is now exploring appropriate governance structures that will support the wider deployment of gen AI tools.

Generative AI is already changing the way professionals do their work in the finance function and beyond. To capture the benefits of these exciting new technologies while controlling the risks, companies must invest in their software development and data science capabilities. And they will need to build robust frameworks to manage data quality and model engineering, human–machine interaction, and ethics. However, as these case examples show, these technologies can accelerate and enable access to critical business information, giving human decision makers the information to make thoughtful and timely choices.

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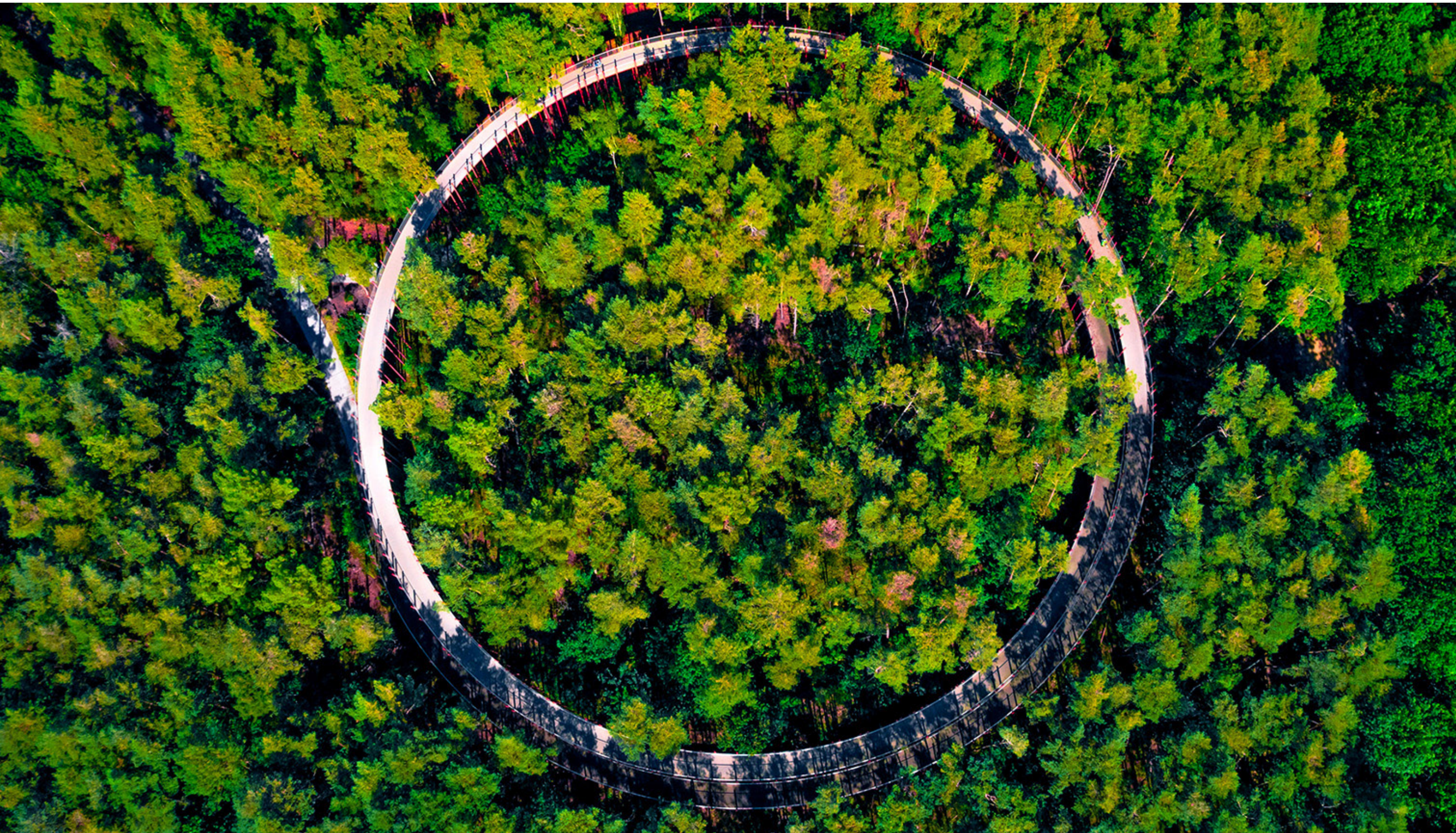
Approaching green M&A

Sustainability is now a strategic objective for many companies. Here's how they can follow a tailored approach.

by Mieke Van Oostende and Nikolaus Raberger
with Felix Rompen and Taimur Tanoli



Many leading companies seek to outperform their competitors by embedding sustainability in their corporate strategies. M&A can complement these strategies.

In sustainability-linked (green) M&A, creating value often relies on using a deal to truly transform the core business, or at least deliver significant revenue synergies. In creating their deal rationale, acquirers should be explicit in what they believe the deal will bring—and this could be quite different from other types of M&A. They will also need to be rigorous in examining what downside risks they need to address. Since the target may be in a completely different business, the acquirer may need to acquire new expertise for the due diligence process. For example, a conventional power company seeking to acquire a renewable project developer will need specific capabilities to assess the value of the pipeline. This could also include expertise in land selection, permitting, procurement, and other areas.

Across sectors, we have seen five broad categories of deal rationales that acquirers can define according to their specific needs, given their various contexts, such as their company, industry, value chain, or geography.

— *Increase exposure to sustainable end markets.* This is an often-cited strategy that directly affects a company's growth prospects and valuation. Prior McKinsey research on specific sectors, such as chemicals, showed that companies with higher exposure to sustainability tailwinds, such as decarbonization and circularity, showed higher growth and shareholder returns. Examples of such deals could be a basic-materials company shifting toward mining lithium to power electric vehicles, or a construction company acquiring a competitor focused on increasing energy efficiency in buildings.

— *Pivot toward lower carbon-intensive production technologies* by divesting noncore, high-emission assets, or acquiring a player with advanced operational capabilities and processes. In a world of high energy and feedstock cost differences across regions, this pivot is increasingly critical for energy-intensive industries such as steel, other metals, paper, and chemicals.

— *Secure advantageous green feedstock.* Examples might include a chemical company acquiring bio-based feedstock, or an industrial company acquiring access to green hydrogen sources instead of gray sources.

— *Inorganically build a reliable and green energy supply.* We have seen selected manufacturing companies go beyond purchase and offtake agreements with energy suppliers and instead directly acquire electricity-generation assets for their major sites.

— *Enhance circularity of the product portfolio.* This means acquiring recycling or carbon-capture capabilities inorganically, limiting downstream emissions. Recyclable plastics provide an opportunity, among many others.

Moreover, the best strategy is meaningless without rigorous execution. McKinsey has previously outlined general best practices of merger integration success, and these generally also apply in green deals. However, these deals require some additional considerations.

For instance, in green M&A—especially in the acquirer's first large green deal—we frequently see an approach that does not seek to fully integrate the target into the acquirer right away but keeps it at arm's length—even into the midterm time horizon. This approach can include how the target is represented to the external world, and also its internal ways of working. Acquirers take time to align the operations and cultures of the businesses.

One reason acquirers do this is to retain critical talent in the target company, which may be active in a field where the acquirer does not yet possess distinctive expertise. Indeed, the acquirer's future success may rely more on the target's personnel than in other growth acquisitions. A combustion-engine technology player that was acquiring

a developer of vehicle battery technology actively addressed talent risk by building targeted growth plans for key people in the acquired company from day one. This highlighted the importance of the acquired business and its people to the new overall corporate strategy.

Beyond the operational integration, value creation in green deals often depends on driving synergetic top-line growth in a new business line or ensuring that a more sustainable product outgrows a less sustainable alternative. While in many acquisitions cost synergies are a critical part of the business case, in green deals, we have typically seen that transformational top-line synergies have higher relative importance.

Finally, cultures in green deals may differ more than in typical industry consolidation deals, requiring more active integration efforts. When a fossil-feedstock player acquired a plastics recycling company, their mission and vision statements were far from aligned. To begin the integration, it was critical to resolve these fundamental issues within the top team. Beyond that, cultural differences more often arise from differences in the day-to-day management practices and ways of working. For example, the plastics recycling company made decisions more swiftly because it was used to a smaller decision circle than the larger player, which had a heavy asset base. In this case, a successful integration required raising awareness of the combined company's culture and converging the previous cultures into it.

Of course, companies need to tailor their integration approach to the deal rationale and strategic context. While the integration governance of these deals does not fundamentally differ from others, we often see companies spending more time on mutual discovery of business models, placing additional emphasis on revenue creation, and putting a sharp focus on talent selection, employee retention, and company culture.

Sustainability-linked green M&A can be an important enabler for company strategy. To maximize the chances of success, leaders crystalize their green deal rationales and take a tailored approach to integrations.

This article is adapted from "Creating value from green M&A," February 29, 2024.

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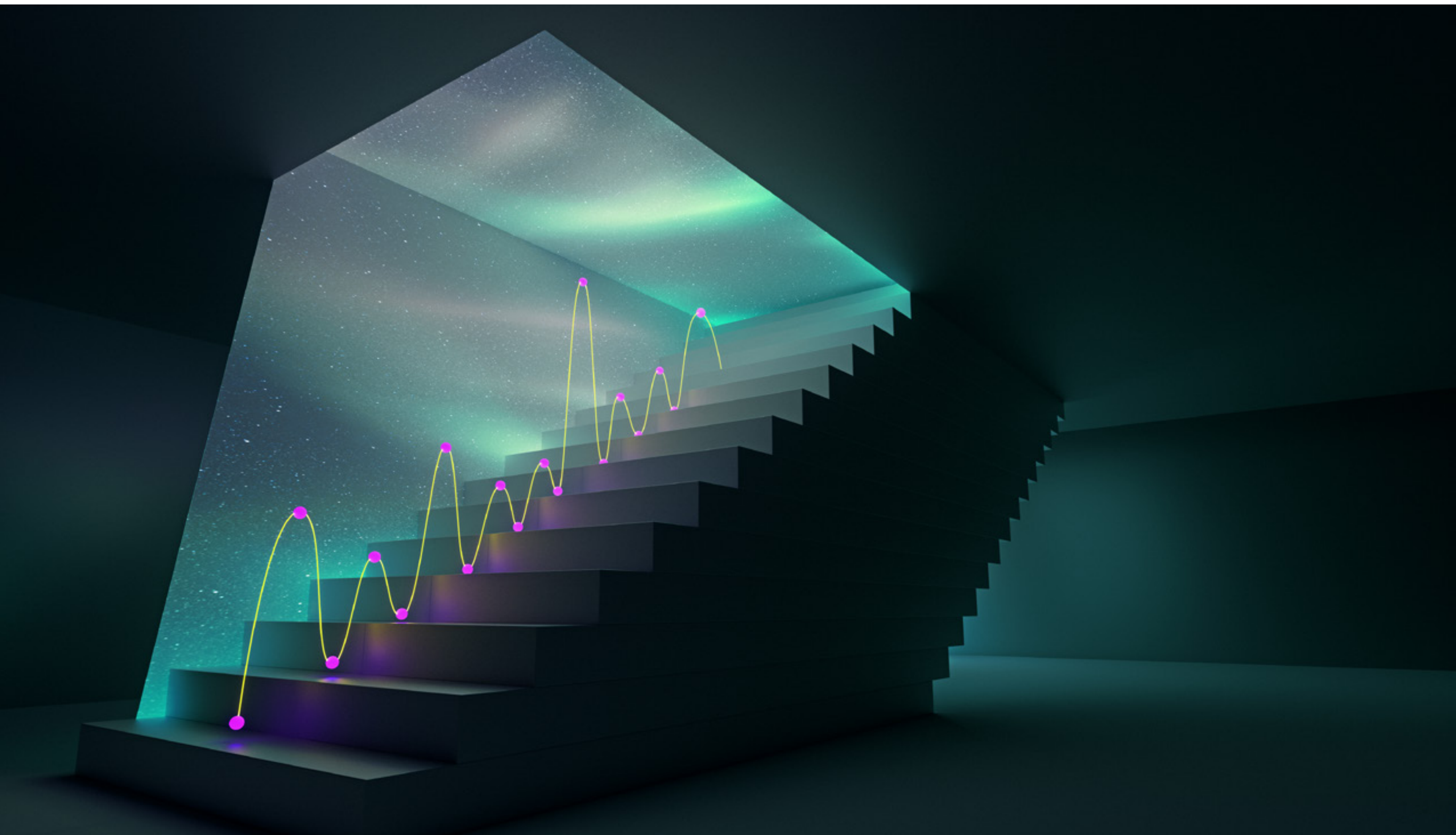
The myth of an enduring index premium

Being included in (or excluded from) a stock index does tend to change the stock price. But the effect disappears in a few weeks.

by Tim Koller
with Marc Goedhart, Margarida Carrasqueira, and Rosen Kotsev

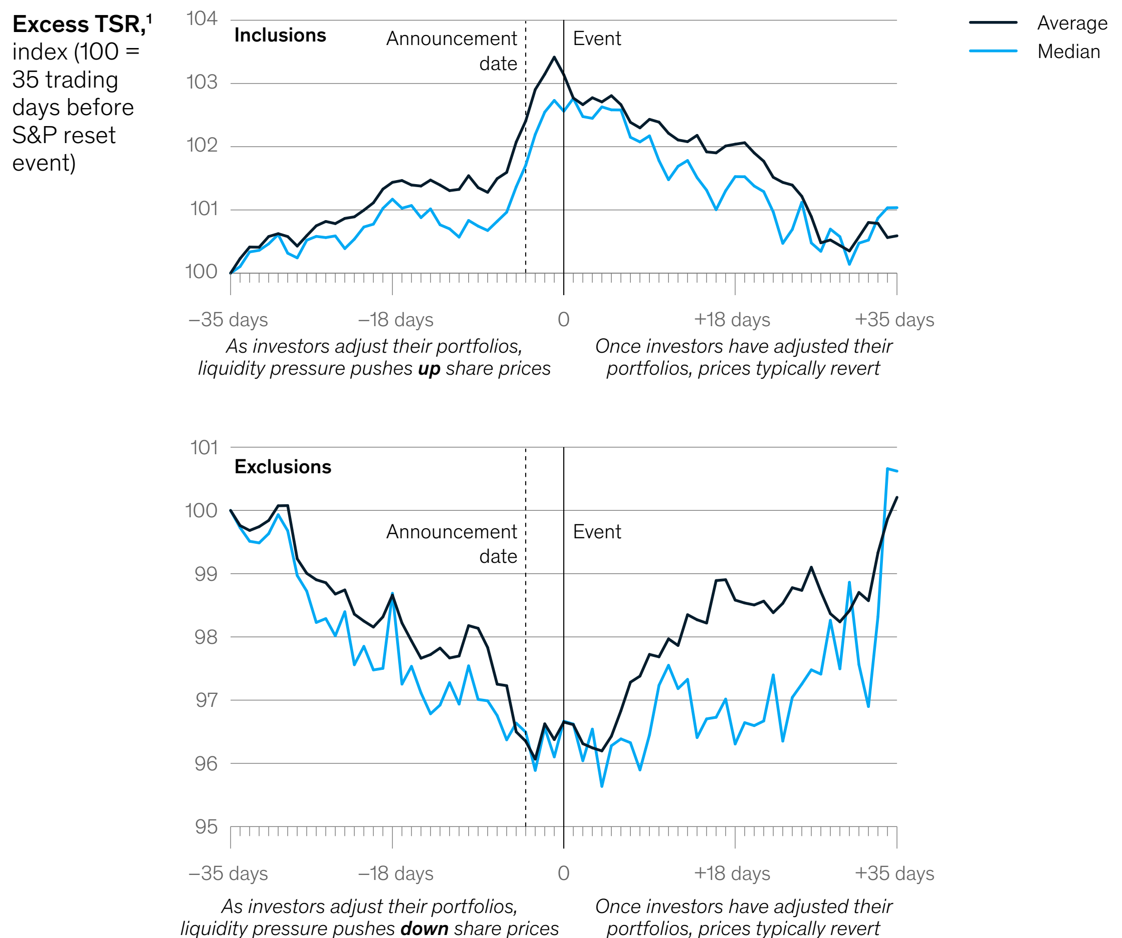


Try this simple thought experiment: imagine you are valuing a company, and you know with absolute certainty the company's financial results for the next ten years, its debt-to-equity mix over that time, its beta, and its costs of debt and equity. Moreover, you have perfect information about the company's peers. In fact, you're missing only one data point—whether or not the company is included on a major stock index (such as the S&P 500 or the FTSE 100). How confident would you be about your valuation?

If you said very confident, congratulations; logically and empirically, index inclusion does not affect intrinsic value. If you hesitated, that's also understandable. In a sense, the market hesitates, too. When an index announces that it is including or removing a company, the company's stock price *does* move—increasing for inclusion, declining for removal. But then the stock price readjusts, typically within two months, as the market moves ineluctably toward the company's intrinsic value.

Exhibit

Being included in or excluded from the S&P 500 does affect a company's share price—but only for a few weeks.



[1]Excess TSR is calculated using the buy and hold abnormal returns (BHAR) method. The benchmark for excess TSR is the S&P 500 Index return.
Source: Corporate Performance Analytics by McKinsey

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We recently analyzed the total shareholder returns (TSR) of hundreds of companies that were included or excluded from the S&P 500 over the history of the index and found that this readjustment still holds true (exhibit). Moreover, the magnitude of change is declining, as investors increasingly anchor on business fundamentals.[1] Index inclusion or removal follows TSR performance, not the other way around.

Precisely because the index effect is ephemeral, boards should not strive for it, and managers should not build a strategy with indexes in mind. For example, companies shouldn't refrain from spin-offs or divestments merely because, by being smaller, they may not be included in an index. Nor, on the other hand, should they pursue share issuances, mergers, or acquisitions for index-related reasons. As a tactical matter, however, they should recognize that whether or not a company is included in an index can, for a short time, affect price—a consideration that matters when key events such as equity issuances or M&A transactions occur.

In terms of investor communications, they should be frank with analysts and investors in explaining that boosts from index inclusions, or declines from index removals, won't create a "new normal" for share price expectations. Instead, they should consistently emphasize that intrinsic value is driven by growth, ROIC, and broader sectoral trends. After all, no one should build a valuation model with "index" as an input.

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[1] See Hamish Preston and Aye M. Soe, *What happened to the index effect? A look at three decades of S&P 500 adds and drops*, S&P Dow Jones Indices, September 2021. Our analysis found a similar decline in magnitude.

Connecting strategy, finance, and personal development: A conversation with Marjorie Lao

The former CFO of the LEGO Group shares insights and lessons for finance leaders.

The CFO is a company's "connector in chief." No one else in the organization is more important for ensuring that strategy, financial controls, stakeholder management, technology, and personal development link together for value creation. Marjorie Lao, who served as the CFO of the LEGO Group—and before that, as CFO of the Norway-based public company Tandberg (now part of Cisco Systems)—managed these connections for more than a decade, and is now a director on multiple company boards. In a conversation with McKinsey's Christian Grube, Lao shares her unique insights about the CFO role. An edited version of the conversation follows.

McKinsey: One of the themes we've been following is the expanding CFO mandate. What do you think is the CFO's biggest priority?

Marjorie Lao: A CFO is responsible for running the full finance function, including capital markets if it's a public company, accounting, tax, treasury, and increasingly, technology—not just as a matter of business efficiency, but in terms of how it can affect business dynamics. That means a CFO needs to have business understanding, finance skills, and leadership and people management skills, including across stakeholder groups. Ultimately, the most important role for the CFO is to drive operating linkages end to end across the whole business. Usually, only the CEO and the CFO have that visibility that cuts across functional or divisional lines. The challenge for a CFO is to build a *business* organization, not just a finance organization, and definitely not just an accounting organization.

McKinsey: Did you always have a strategy-first perspective?

Marjorie Lao: I'm a CPA by training. But my first two jobs after university—Procter & Gamble and McKinsey—were good training grounds for strategy and business. I had joined Tandberg as head of strategy and business development, and when the company needed a new CFO, we were in the middle of an acquisition—an acquisition that was going to give us a competitive advantage. The company needed someone who understood the business, could work with the sales and other business leaders, understand the momentum case, and tie it to the forecast.

With my McKinsey training, I was prepared to be the CFO from a strategy perspective. I was less prepared for the rigors of accounting. But I realized that I could delegate more technical responsibilities to team members who were much stronger in accounting than I am. However, I also took it as a learning opportunity—given the pace of change in our industry and company, I also needed to make sure that I understood the accounting so that we wouldn't get caught by surprise. I rolled up my sleeves and sat through several quarter ends with the chief controller to get an understanding of what we are doing and how we are doing it, while ensuring that different groups within finance—from accounting to financial planning and analysis—are also in sync.

McKinsey: How did you transition to the CFO role at the LEGO Group?

Marjorie Lao: I was initially hired by the LEGO Group as SVP of finance, reporting to the CFO. I remember one of my early projects was to drive what we called "pinnacle KPI" thinking, which is to say that each department or function may have their own objectives or metrics—but ultimately, these have to tie into the overall goals of the company. For instance, in supply chain, one of the objectives may be to maximize inventory turns, while in sales it may be to maximize on-shelf availability. How do we then look at this as a company from an end-to-end perspective—and this was a conversation that our finance team led with more than 100 business and functional leaders.

This early experience in getting the end-to-end perspective was quite foundational and helpful when I was promoted to the CFO role two years later.

McKinsey: Was it hard to embed finance throughout the organization right away?

‘Ultimately, the most important role for the CFO is to drive operating linkages end to end across the whole business. Usually, only the CEO and the CFO have that visibility that cuts across functional or divisional lines.’

Marjorie Lao: When I first started, as part of my onboarding, I had the benefit of talking to and learning from the senior vice presidents leading the different functions and units in the company. One of our discussion points was, to what extent does finance have a seat at the table when it comes to decision making in the function and BU [business unit] management teams? As I reflected on these discussions, I realized that one of our most important priorities was to establish our credibility as a finance organization, that is, “How do we, in finance, create value so that we *are* invited to the table?”

As a finance organization, we had to establish credibility so that people don’t see us and think, “OK, it’s the numbers persons again. We’ll talk to them when we need approval.” It’s our responsibility to show the business leaders that we understand the business, we ask the right questions, we enable the right decisions, and we help drive value creation.

One of the things that my team and I aligned on is that our role in decision making is not necessarily the person always saying “no”—sometimes, that’s what the perception of finance is—the ones who say, “We cannot do that, because we don’t have the money,” or “We don’t have the approval,” or “There’s too much risk.” Our role instead should be to consider saying, “*Yes*—as long as we do this,” or “*Yes*—under these conditions.” This required a change in mindset: finance as an enabler of business, beyond just being a guardian of controls.

McKinsey: What are some nontraditional ways you’ve enabled your companies’ businesses?

Marjorie Lao: Early in my CFO role at the LEGO Group, I was lucky to have had a broader-than-traditional responsibility—covering ESG [environmental, social, and governance], legal, and government and public affairs. There’s a parallel there to how we think of the finance function in the organization: how we can contribute value and establish credibility.

As an example, instead of viewing these functions as *just* focused on compliance and risk avoidance, how do we take a more strategic approach and make our work a more integral part of the business? This included being proactive in our approach to being a good corporate citizen, such as launching initiatives in our local communities to educate children on the importance of the environment, and working with our business leaders and channel partners on the same.

McKinsey: Are there lessons you would you impart to your younger self to make things easier?

Marjorie Lao: I would probably tell my younger self to quickly assess what capabilities and skills my direct team and I have versus what are needed for us to be successful, and quickly supplement or complement our team with the right people and the right capabilities. And I emphasize "quickly." Often in the past, I had the mindset of, "I can try to make this work." I held on to this thinking too long, and it took me quite some time to build the right team, including changing out people as needed. In hindsight, this pace of building the right team is what I would have redone.

At the same time, I take pride in the finance organization being a net exporter of talent. And this I would advise my younger self to continue doing. I think of my team as business leaders and future CFOs. They have a role that they're working on right now—how can I help them understand their potential and continue to build that potential, in their existing roles as well as possible next roles? That includes exposure to areas that they normally may not have access to, including attending audit and other board committee meetings, for instance.

When I think of learning opportunities for the team, it goes beyond my direct reports. For instance, shortly after key meetings, I would debrief our finance team on what was on the management team and board agenda, what were the key questions that were discussed, and what that meant in terms of feedback on what we as a finance team could be doing better or differently. On one hand, this helps ensure that we as a finance team are in sync. At the same time, this also provides a learning opportunity for the broader team. As CFO, I can't have my hands on everything. But one of the most impactful things I can do is to have mini-CFOs all over the organization who share a business-enabling vision.

Marjorie Lao is the former CFO at the LEGO Group and former senior vice president and CFO at Tandberg (now part of Cisco Systems). She sits on the boards of GoTo (Gojek/Tokopedia) Indonesia, Logitech, and MYT Netherlands. **Christian Grube** (Christian_Grube@McKinsey.com) is a partner in McKinsey's Munich office.

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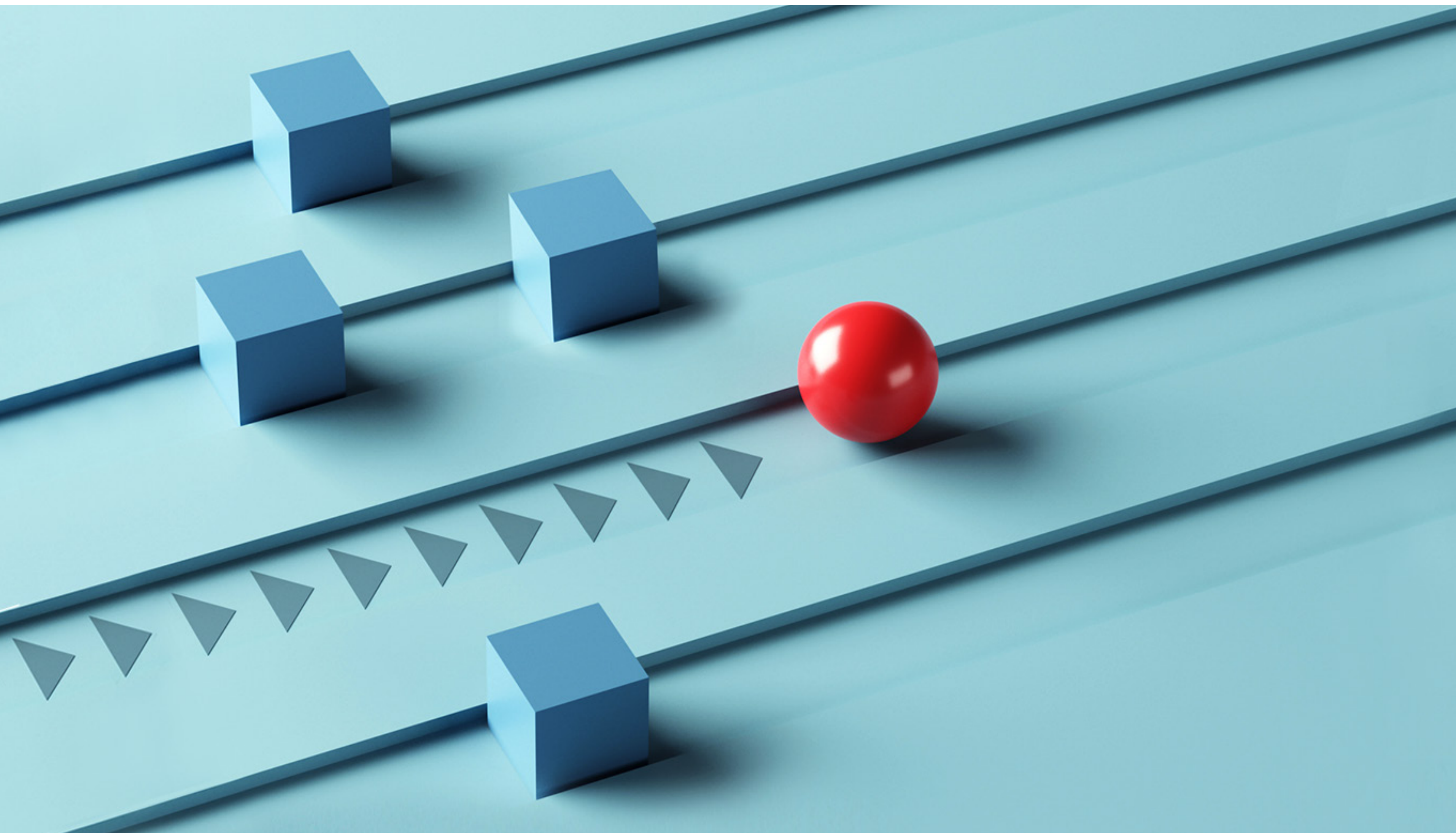
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

Next in line? A structured approach to succession planning

by Tim Koller
with Derek Schatz



The dilemma

When the founder CEO at one midsize oil and gas company originally announced his retirement, operations were solid, health and safety metrics were good, and the business was profitable. More recently, there were signs of decline in all those areas, and at least one of the newer members of the board viewed the CEO's retirement as an opportunity to right the ship. A formal CEO search could bring fresh ideas and leadership into the organization just when it needed them the most, she thought.

But the CEO had already chosen his successor: a senior executive whose career path and leadership style mirrored those of the outgoing CEO. The board didn't see the point in engaging in a long, drawn-out process when there was a viable, hand-picked internal candidate in the picture. Instead, directors voted unanimously to confirm the retiring CEO's pick to lead the company.

Nine months later, amid cratering investor confidence, the board reconvened—this time to vote the new CEO out.

The research

One of a board's most important tasks is to ensure the successful transition of power from one CEO to the next. Yet McKinsey analysis has shown that between 27 and 46 percent of executive transitions are viewed as failures or disappointments after two years.[1]

To succeed with succession planning, boards must recognize and address their—and potentially, the outgoing CEO's—tendencies toward similarity bias. This occurs when individuals are inclined to evaluate more favorably or behave in a more positive manner toward people they perceive as sharing their own identities or other characteristics. Research has shown, for instance, that venture capitalists are more likely to evaluate an investment opportunity favorably if they believe the founding entrepreneur thinks in a way similar to their own.[2]

The departing oil and gas CEO wanted to replace himself with someone who had similar priorities and philosophies, even if they weren't what the company needed right then or might need in the future.

To succeed with succession planning, boards must recognize and address their tendencies toward similarity bias.

[1] Scott Keller, "Successfully transitioning to new leadership roles," McKinsey, May 23, 2018.
[2] Niek Strohmaier et al., "Similarity bias in credit decisions for entrepreneurs on the brink of bankruptcy," *Journal of Applied Social Psychology*, July 2021, Volume 51, Number 7.

Meanwhile the board of directors reflexively deferred to the founder CEO's vision of what was required for success in the CEO role. They were exhibiting the representativeness heuristic rather than seizing an opportunity for organizational renewal.[3]

In the end, the oil and gas company managed to stabilize its performance, but only after installing an interim CEO to manage the company through a full CEO search and transition process—an incredibly disruptive and expensive course correction.

The remedy

A good old-fashioned task force, established by the board long before any executive departures are announced or even considered, can help depersonalize the succession-planning process. In this way, companies and boards can ensure that they're getting or building the leadership talent that they need to keep up with their industry.

In the case of the oil and gas company, forward-thinking board directors could have invited the CEO to join with other C-suite, business unit, and HR leaders to form a succession-planning committee. The committee members could have met regularly to review the CEO's criteria for the ideal successor and mapped them against others' criteria for identifying and selecting the most appropriate candidates (internal and external). They could have provided regular succession-planning updates to the full board. The CEO would still have had significant input in the process, but there would have been room for others, like the newly joined board member, to consider who might be the best leader for the organization given current and future business needs—and to suggest their own candidates.

The task force could also have suggested possible development opportunities for likely internal candidates—job rotations, stretch assignments, and mentoring, for instance. All of this would have been less costly and less time consuming than simply going with the comfortable candidate.

Rather than fear the inevitable CEO departures and having to start from scratch, companies and boards should be thinking about the next CEO as soon as the current one is hired.

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The authors wish to thank Eileen Kelly Rinaudo for her contributions to this article and the *Bias Busters* series.

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[3] Chengwei Liu, Dawn L. Eubanks, and Nick Chater, "The weakness of strong ties: Sampling bias, social ties, and nepotism in family business succession," *Leadership Quarterly*, June 2015, Volume 26, Number 3.

Six ways CFOs find the time to unlock their full potential

It's hard to create outsize value when you have to manage the finance function's daily and often urgent demands. But some CFOs rise to the challenge.

by Ankur Agrawal and Matthew Maloney
with Abhishek Shirali and Meagan Hill

Call it the CFO conundrum. As your company's most senior finance executive, you understand that your most important mission is to enable significant value creation. That means finding a way to shift from "just" keeping a complex finance function on the rails to establishing yourself as the CEO's principal thought partner—rather than, as some CFOs confide, being considered "a glorified accountant." For some CFOs, the challenge can be even more intense. Instead of being carefully prepped for succession over the course of years, they find themselves thrust into the top role unexpectedly, perhaps when the business is in distress, emerging from an ownership change, or dealing with a tail-event crisis (as occurred with the COVID-19 pandemic or as is playing out today with geopolitical conflicts). They simply *must* carry the mantle forward. Urgent requirements, including cash management, internal and external reporting, talent development, risks and controls, and scenario planning, can't be wished away.

But even following the most favorable transitions, many CFOs ask how they can conjure up the massive amount of time required to run a company's finance function and also be a thoughtful, strategy-first leader. And how, in the face of the enormous complexity of pressing and even competing demands, can they establish the credibility to have other senior leaders view them as the de facto "deputy CEO"? If only they had more time, they could be *that kind* of CFO. But because they're not that kind of CFO, they need to scramble to invest even more time.

Yet some CFOs do rise to the challenge. In this article, we'll explore how they raise their games above functional expertise to achieve real strategic impact. By improving in six critical dimensions, they solve the time-crunch challenge to become enterprise-wide leaders, superior decision makers, and value-creating confidants of CEOs—all while running a more efficient, dynamic, and farsighted finance function.

1. Crystalize your strategy—and identify where technology can be an enabler

As our colleagues noted more than a decade ago, "strategy is a way of thinking, not a procedural exercise or a set of frameworks."[1] Yet too often, CFOs find themselves solving for procedural exercises or framework elements. They iterate on small items without pausing to consider how much these details really matter to executing the company's strategy and plow ahead with the same routine without considering which systems could be radically improved and which tasks could be thoroughly automated.

The best CFOs ask elemental questions. They focus on core, strategic issues, such as identifying new sources of growth and realizing the highest risk-adjusted returns for company capital. They also ensure that they have disciplined strategy development processes, with metrics expressed in common finance terms (such as revenue and cost of sales) and business metrics that flow directly to financial results (for example, customer retention rate or inventory turnover). Clear strategy-based targets enable easy tracking, hold people accountable for results, and help maximize value creation. Like a world-class athlete, effective CFOs slow things down and simplify. For example, they take the three- to five-year longer-term strategic plan that has been translated into a straw man set of financials and then use it as a starting point for targets in the upcoming year when approaching budgeting—continuing to stretch aspirations in a realistic way and accelerate how quickly the company reaches its clear objectives. The best CFOs understand key pain points, analyze and align their organization's incentive structure, and assess current capabilities, particularly IT systems and tools.

One senior finance leader, faced with a deluge of performance data and a need to produce an

[1] Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 1, 2011.

accurate, accessible forecast, paused a meeting to ask the crucial question: "How can we make this process go like lightning?" In this particular instance, the solution was found in automating a critical step in the forecasting process. Today, particularly with emerging, commercially practicable solutions in generative AI, automation can have an even greater impact. Cash flow and revenue forecasts that used to take teams weeks to produce can now be generated in minutes. Competitor investor presentations can be quickly synthesized as well to provide at least a solid first draft of likely questions from analysts—and initial versions of answers. And initial drafts of securities filings and stakeholder presentations (such as sustainability reports) can not only be generated near-instantaneously but also checked against current regulations and standards.

As part of one company's financial-planning process, the CFO created a formal discussion format that focused on a few fundamental questions: How is the financial plan supporting strategy? Which resources (talent and capital) are we removing from last year or redeploying to this year? And how will we know that we need to course-correct—and when will we make these choices? Previously, these were disconnected processes. Now the simplicity of the questions allows the CFO to more directly link strategy to financial planning. The CFO also uses a tailored planning solution to ensure a common understanding of the drivers and probabilities of revenue and cost goals and early team collaboration. The improvement not only saves time but is also much more accurate than the company's earlier, off-the-shelf spreadsheet software and its disjointed decision process.

2. Focus on big moves

One of the most consequential ways to cut down on the little things is to focus on what's big. Incrementalism demands a lot of effort, but it won't unlock major change. Our research shows that, perhaps counterintuitively, leaders tend to achieve better results in terms of both top- and bottom-line performance when they focus on the whole rather than the sum of its parts. For resource allocation, CFOs should think in terms of shifting more than 60 percent of annual capital expenditure to different business units every ten years; however, depending on your company's specific industry, the time period may be much shorter. Other hallmarks of big moves are gross margin improvements that place your business within the top 30 percent of its industry, SG&A productivity improvements within the top 40 percent, and labor productivity improvements within the top 30 percent of peers.

For example, a CFO in the life sciences industry focuses personal time on capital allocation and has only three main priorities—business development of innovative products, funding for clinical development to support internal programs, and support for the successful launch of the largest commercial product. This focus on capital allocation allows the CFO to home in on the team and drive the big moves that matter most to the company.

3. Radically simplify

The most effective CFOs radically simplify their function. Even among smaller or midsize companies, it's not unusual for finance departments to have hundreds, or even thousands, of reports that its employees must fill out. Often, the information is duplicative—or worse, not connected to strategy. Duplication also extends to an employee's responsibilities and roles: the same task, with some variation, can be the responsibility of multiple people. In one major agribusiness, for example, three separate managers, in two locations, were responsible for tracking the enterprise's purchase orders. And in a leading national airline, the CFO discovered that employees in external communications regularly released data that decidedly did not align with key messages from investor relations. Effective CFOs get ahead of that kind of disconnect by mapping out roles and responsibilities—which, in turn, allows them to have the most important details at the ready. They put themselves into their CEO's shoes and imagine what *they* would ask if they were running the company. One highly effective CFO who thinks at the enterprise level was referred to by the CEO as a "walking encyclopedia." It's a remarkably apt

analogy: one person *can't* know everything, but they can be proactive in identifying what are likely to be the most important issues.

Effective CFOs save time and achieve stretch goals by clearly identifying potential outcomes and keeping their teams focused on what's needed to create outsize value (exhibit).

To measure the impact of their initiatives in a nontheoretical way, it's essential to start with a "do nothing" momentum case (to represent the true, declining baseline if no business improvements are made) and a range of outcomes from budgeted initiatives.

Budgeted initiatives create a new baseline for expected EBITDA. Recognizing concrete, higher targets enables companies to create significantly more value.

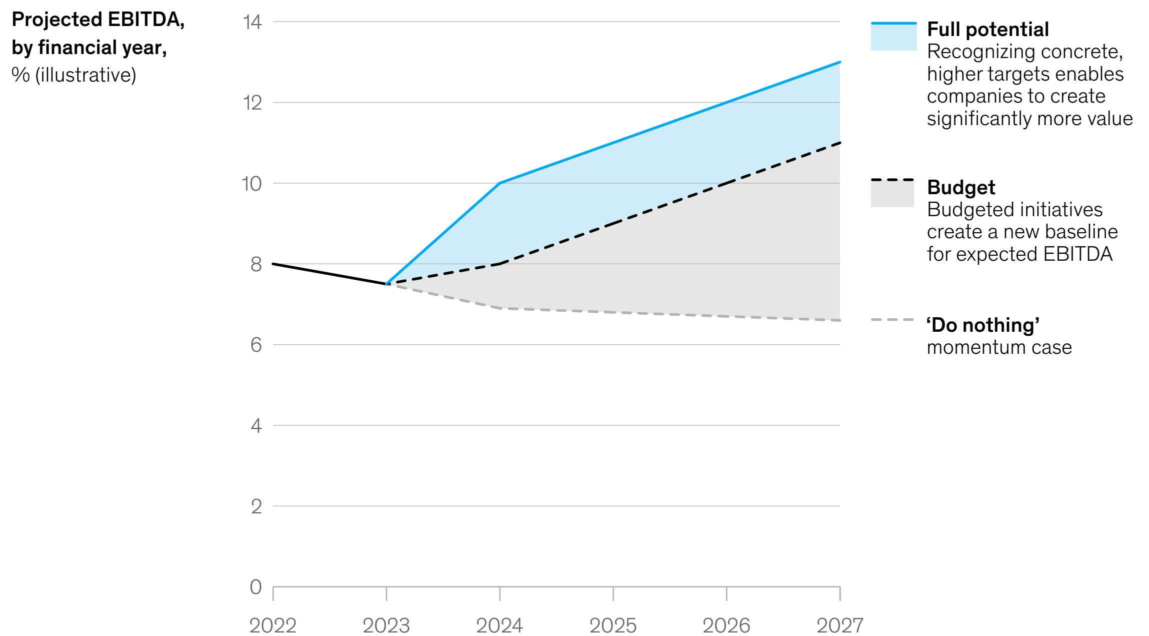
To measure the impact of initiatives in a nontheoretical way, it's essential to assess how the enterprise performs compared with its peers (including on a business segment level), to identify core performance differentiators (for example, growth and margin expansion), to size investors' current and potential expectations for each major business, and to call out and constantly strive to meet clear performance indicators and targets.

4. Keep up the tempo

It's true: some days will be busier than others, and some periods—such as a major acquisition, a materially adverse event, or even the days immediately preceding and including key quarterly or annual financial results—can be especially intense. But every day should not feel like a new crisis.

Exhibit

Effective CFOs save time and achieve stretch goals by clearly identifying potential outcomes.



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The most effective CFOs save time by investing effort to build the tools, reports, and calendars that enable agile change. This starts with the basics of performance management, including standardized templates, clear action items, and targeted outcomes that are regularly updated to track progress. CFOs and their teams should have a standardized playbook outlining key questions to evaluate actual and forecasted results for the momentum case, investments, and initiative tracking. They should also establish clear guidelines on when ad hoc analyses are needed (for example, variance management based on a defined threshold) and clarity on processes, governance, and timelines. And to ensure that the most impactful projects are receiving the resources they need, CFOs should meet with their senior team members, and ideally the CEO, at least weekly to track resource allocation.

The CFO of one industrials company dramatically reduced the number of meetings they attended and instead delegated the monthly reviews to the financial-planning and -analysis leader. This CFO also made one-on-one meetings more focused on personal development, as opposed to content area reviews. The meetings that they have with teams (and their personal time) are focused on a set of issues that are directly linked to the strategy and performance of the company. Other functional and business leaders are invited to the meetings based on the topics, eliminating the need to track them down later and slicing decision-making time as a result.

5. Overcome cultural inertia

Financial performance is ultimately measured by hard numbers, but some of the biggest time sinks aren't mathematical; they're behavioral. Common human biases, including tendencies toward risk avoidance and loss aversion, show up frequently in large organizations, bog things down, and lead to worse results.

There are several shifts that CFOs can make to overcome time-wasting inertia. For starters, they should be clear about what their strategic priorities are, rather than getting sidetracked by glamour projects or, even worse, relegating the strategic plan to being just one more item on their to-do list. A best practice is to track the company's portfolio of initiatives across multiple horizons and update strategy based on how the company actually progresses, comparing three years' preceding results against the three-year-forward plan on a continuing basis.

CFOs should not waste time solving for consensus. The most effective leaders frame strategy around major choices, calibrate aspirations against their company's endowment and industry as well as broader macroeconomic trends, and relentlessly prioritize. To break free of groupthink, CFOs can use practical debiasing techniques (such as red teams and blue teams and devil's advocates) and bring outside experts into the room. Their highly performing teams compare actionable, alternative plans with different risk and investment profiles, track assumptions over time, and build contingencies into planning to rapidly evolve choices as the CFO learns more. Meanwhile, they can save time and eliminate petty squabbles by adjusting incentives so that managers of all businesses are rewarded when the organization as a whole outperforms.

The most effective CFOs address challenges proactively. Among other steps, they confront budgetary sluggishness by freeing up resources as much as a year before their strategy will need to deploy them, adapt "80 percent–based budgeting" when possible to keep more resources liquid, and charge managers an opportunity cost for their resources, incenting them to free up capital rather than hoard it. They take on sandbagging by forcing hard conversations for major improvement, significant growth, and meaningful commitment; tailor approaches to no-regret moves, big bets, and real options; and adjust metrics and incentives to reflect the risks that people are taking. For example, they reflect higher or lower probabilities of success in their compensation structures, using team metrics that extend over longer time horizons in riskier contexts, and encourage "noble failures," focusing on the quality of the participant's game and the value of the potential candle. Finally, rather than

getting bogged down by people's apprehensions about the enormity of long-range planning, effective CFOs force the first step. While they have a clear vision of long-range objectives, they disaggregate the long run into practical six-month increments—starting with the first six months—and set short-term goals based on fundamental criteria. The objective is to focus more on what's really driving the short-term numbers and less on a business's monthly or quarterly profit and loss statements and continually identify where more resources are more immediately needed.

6. Mind your microhabits

A final, critical component of being a time-efficient CFO is to practice effective microhabits—daily practices and ways of working that make for a more effective leader. Small actions and discrete steps can make an enormous difference.

The first microhabit, which may be perceived as the most challenging of all, is to be frank when managing up. This starts with speaking with the CEO. It's common for CFOs, particularly ones who are early in their tenure, to assume they and the CEO are aligned on key priorities. An effective CFO makes those understandings explicit. There are several ways to clarify priorities and action plans, even understanding that the *best* approach depends on the styles of the individual CEO and CFO. Practical tips include a monthly email that a CFO writes to the CEO, a specified agenda for regular one-on-one catch-ups, and a formal professional-development plan that defines priorities up front. By being clear and specific, CFOs can better prioritize and be more effective both in investment committee meetings and in running the finance function.

In addition to the CEO, CFOs should invest in managing their relationship with the board. It's not uncommon for individual directors to have different perspectives and expectations. While that can seem frustrating, an effective CFO turns those nuances into time savings; the more a CFO understands what a director seeks, the better a CFO can manage time to provide it—and indeed, anticipate it. It's extremely rare for a board to be overtly adversarial; directors are, after all, solving for the best interests of the company and its shareholders. But if there are disagreements, we find that boards appreciate a CFO who can plainly state the question (for example, should we or shouldn't we write down an investment), provide clear facts, and identify pros, cons, costs, and benefits—and then enable the board to address a problem before it reaches a critical stage.

In addition to managing up, effective CFOs also excel at managing themselves. One effective microhabit is to sit down and write a memo to yourself about your most important priorities; doing so helps immediately, simply by making these points clear to yourself. It then continues to pay off as you review it, ideally every quarter. Counterintuitively, taking time for reflection is a *time-saver*. It lifts you out of the hustle and bustle and allows you to re-center on key goals. Another useful practice is to reduce meeting time, frequency, and number of participants. It's rare that a 60-minute meeting can't be reduced to 45 minutes, and that 30 minutes can't be sliced into 20 or 25. Keeping to the clock helps cut right to the business at hand. A similar dynamic applies to meeting frequency. Daily meetings can almost always be replaced by weekly ones. Monthly meetings, depending on what the subject is, can be every two months, or even once a quarter. And meetings themselves should be limited to decision makers and those who can immediately help them; if a meeting doesn't end with a *decision*, it probably shouldn't have been held in the first place. While "town halls" are useful—your team should not view you as someone who sits in an ivory tower—the absolute number should be limited. Otherwise, the CFO will be called to sit in on or lead too many meetings or calls and lose valuable time as a consequence.

Finally, to be at your best, CFOs should strive to stick to a fixed routine. Without sounding too much like a parent: get exercise, have a shutdown time for unwinding, and get enough sleep. Set aside time for your family and personal life. Multiple senior leaders have shared with us that they've achieved their greatest insights during or immediately after the time they've set aside to unplug. If fixing

work–life boundaries sounds like an impossible goal, we can assure you that we've worked with dozens of CFOs who successfully make it work. They are more energized, efficient, and effective after starting and then sticking to their routines.

CFOs face an extraordinary set of concurrent challenges—to carry out company strategy enterprise-wide; manage a complex, detail-based function; and serve as the confidant and critical thought partner of the CEO. It takes exceptional discipline and focus to find time for it all, particularly for CFOs who find themselves thrust into the role. Yet by minding six critical sets of actions, the most effective CFOs do find the time to make it all work and help the company create outsize value for the long term.

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Looking back

Do shareholder activists create lasting value?

A shareholder activist tends to improve a company's stock price during its campaigns—and sustains those gains for three years after the campaign is announced. But when one considers the period *after* an activist has exited its position, the picture becomes murkier.

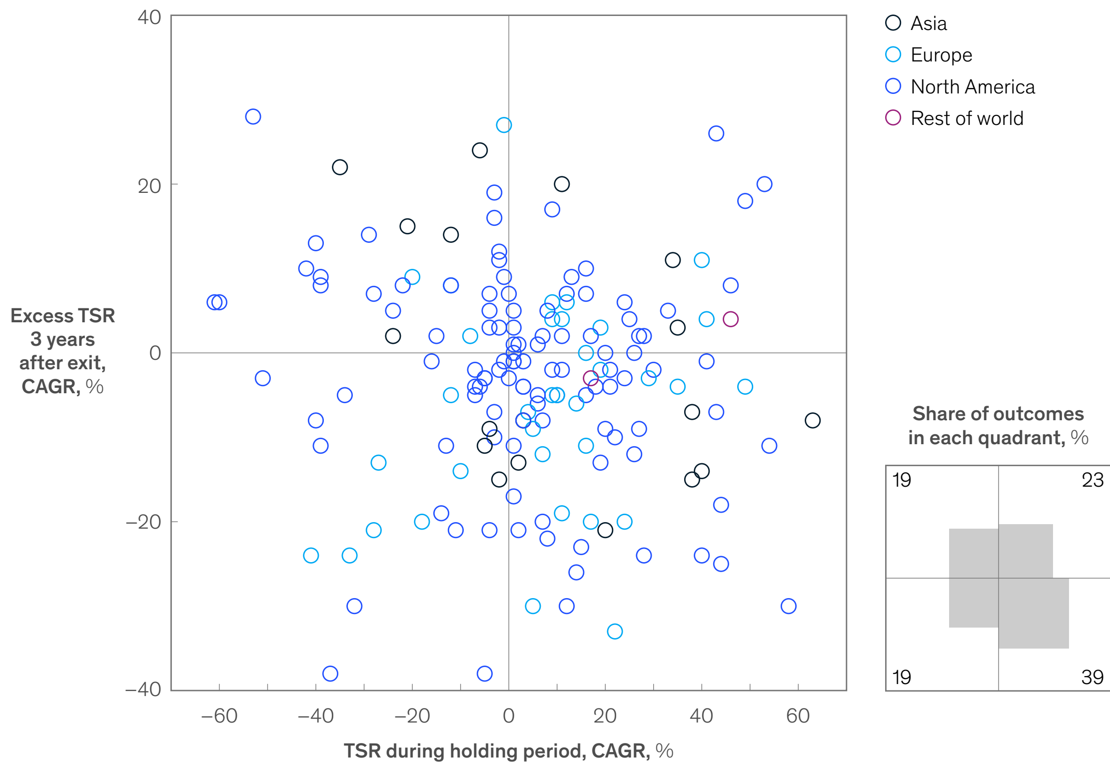
We examined almost 170 shareholder activist campaigns worldwide over the past ten years and found that *after an activist had exited their position*, three-year excess total shareholder returns (TSR) were negative in about 40 percent of the companies that had experienced positive returns while an activist held their stake. This was nearly double the number of companies (23 percent) that continued to see positive returns over the three-year, postexit period (exhibit).

There are likely several reasons why companies do not sustain returns after activists have exited. When a company's stock price runs ahead of its fundamentals, activists may sell to realize their gains (the activist's own investors, after all, are also seeking high returns). Moreover, even when

Exhibit

Shareholder returns often are not sustained three years after an activist shareholder has exited their position.

Company share performance during activist holding period vs 3 years after activist exit[1]



[1]Based on 166 activist campaigns in 2010–20. Asia, n = 18; Europe, n = 35; North America, n = 111; rest of world, n = 2. Excess returns measured against respective sector indexes for all companies. Absolute returns shown where holding period is less than 1 year.
Source: Insightia (Diligent Market Intelligence); S&P Capital IQ

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the company’s intrinsic and market valuations are aligned, higher performance cannot be sustained forever. As the pace of earnings growth decelerates, TSR declines as well. And, of course, some activist investors aren’t playing for the long term; they make short-term fixes but don’t push for fundamental, sustainable changes. Nor are activists always *right* in their campaign decisions; in fact, they incur losses in almost two out of five campaigns.

As always, broader context matters. Not only is it often impossible to measure precisely when activists begin to accumulate shares, since they can often acquire positions below an undetectable regulatory red line (such as, in the United States, more than the 5 percent of a class of covered equity shares that would require a Schedule 13D filing), but it may be that the “long run” is a lot longer than just the several-year period during which a shareholder activist first announces, and then exits, a position. For nonactivist shareholders that invest for longer periods of time, the announcement of an activist campaign could be a long-term net positive for the company, even considering a decline in TSR following the activist’s exit. Just because a shareholder activist seeks to maximize their own returns over the period in which they hold company shares does not mean that the activist campaign, and the eventual exit of the activist, destroys long-term value—or necessarily creates it.

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DECISION MAKING

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Charles Conn and Rob McLean, with Sean Brown

Thinking like a digital company: An interview with Kevin Strain
Sun Life president and CEO Kevin Strain is joining forces with insurtechs and breaking down barriers between IT and business to help the 150-year-old company better fulfill its purpose.
Kevin Strain, with Tanguy Catlin

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Using M&A as a launchpad for transformation
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Executing regular small deals is not only the most effective M&A strategy but also makes companies more resilient. Here is how programmatic acquirers beat the market.
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