The **misguided practice** of earnings guidance

Companies provide earnings guidance with a variety of expectations—and most of them don't hold up.

Peggy Hsieh, Timothy Koller, and S. R. Rajan

Most companies view the quarterly ritual of issuing earnings guidance as a necessary, if sometimes onerous, part of communicating with financial markets. The benefits, they hope, are lower share price volatility and higher valuations. At the least, companies expect frequent earnings guidance to boost their stock's liquidity.

We believe that they are misguided. Our analysis of the perceived benefits of issuing frequent earnings guidance found no evidence that it affects valuation multiples, improves shareholder returns, or reduces share price volatility. The only significant effect we observed is an increase in trading volumes when companies start issuing guidance—an effect that would interest short-term investors who trade on the news of such announcements but should be of little concern to most managers, except in companies with illiquid stocks. Our recent survey[1] found, however, that providing quarterly guidance has real costs, chief among them the time senior management must spend preparing the reports and an excessive focus on short-term results.

These results pose an intriguing question: if issuing guidance doesn't affect valuations and share price volatility, why should a company incur the real costs of issuing it merely to satisfy requests from analysts?

Our conclusion: to maintain good communications with analysts and investors, companies that currently provide quarterly earnings guidance should shift their focus away from short-term performance and toward the drivers of long-term company health as well as their expectations of future business conditions and their long-range goals.[2] Companies that don't currently issue guidance should avoid the temptation to start providing it and instead focus on disclosures about business fundamentals and long-range goals.

A dearth of benefits . . .

The practice of issuing earnings guidance became more common during the latter half of the 1990s, after the US Congress protected companies from liability for statements about their projected performance.[3] Since then, the number of companies issuing quarterly or annual guidance has increased—though in recent years the trend has begun to slow. Our review of approximately 4,000 companies with revenues greater than $500 million found that about 1,600 had provided earnings guidance at least once in the years from 1994 to 2004. The number of companies that did so increased from only 92 in 1994 to about 1,200 by 2001, when the rate of growth leveled off. The number of companies in our sample that discontinued guidance has also increased steadily, growing to about 220 in 2004 (Exhibit 1).

In our survey, executives attributed several benefits to the practice of providing earnings guidance, including higher valuations, lower share price volatility, and improved liquidity. Yet our analysis of companies across all sectors and an in-depth examination of two mature representative industries—consumer packaged goods (CPG) and pharmaceuticals—found no evidence to support those expectations. The findings fell into three categories:

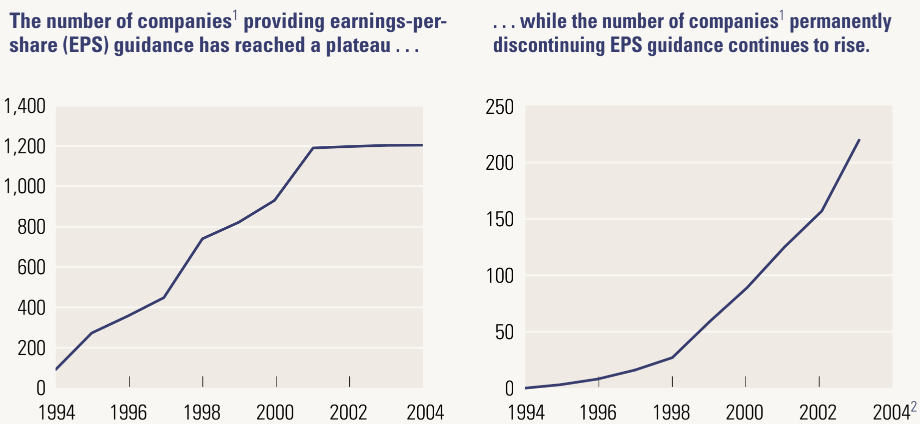
[1] "Weighing the pros and cons of earnings guidance: A McKinsey Survey," *The McKinsey Quarterly,* Web exclusive, February 2005 (www.mckinseyquarterly.com/links/21063). The survey's respondents included 124 CFOs, CEOs, and board members from around the world, from nine industries and companies ranging in size from $10 million to $30 billion.

[2] Richard Dobbs and Timothy Koller, "Measuring long-term performance," *McKinsey on Finance*, Number 16, Summer 2005, pp. 1–6. (www.mckinseyquarterly.com/links/21167).

[3] The Private Securities Litigation Reform Act of 1995.

EXHIBIT 1

Signs of a trend?



[1]Among companies with real revenues >$500 million at any time from 1990 to 2004.
[2]Data for 2004 not available.
Source: Thomson; McKinsey analysis

Valuations. Contrary to what some companies believe, frequent guidance does not result in superior valuations in the marketplace; indeed, guidance appears to have no significant relationship with valuations—regardless of the year, the industry, or the size of the company in question (Exhibit 2).[4] From 1994 to 2004 the median multiples for consumer-packaged-goods companies track one another fairly closely, whether or not they issued earnings guidance. While the median multiple for companies that did issue guidance was higher from 2001 to 2004, the underlying distribution of multiples for both groups was comparable. Indeed, the averages of the two distributions are statistically indistinguishable. Our findings are similar in other industries, though their smaller sample sizes create more scattered data.

Moreover, in the year companies begin to offer guidance, their total returns to shareholders aren't different from those of companies that don't offer it at all (Exhibit 3). When we compared the TRS of CPG companies in the year they started providing guidance with that of peers that didn't issue it, the distribution of excess returns[5] was centered around zero. This analysis supports our finding that the market has no reaction to the initiation of guidance. The absence of excess returns also holds for the year after guidance starts.

Volatility. When a company begins to issue earnings guidance, its share price volatility is as likely to increase as to decrease compared with that of companies that don't issue guidance. We looked at the ratio of the standard deviation of monthly TRS in the year of initiating guidance to the previous year and found virtually no difference between companies that do or don't offer it. Of 44 CPG companies that began offering earnings guidance, 21 experienced increased volatility and 23 showed a decrease compared with companies that don't offer it. What's more, the findings were similar regardless of company size.[6]

Liquidity. When companies begin issuing quarterly earnings guidance, they experience increases in trading volumes relative to companies that don't provide it.[7] However, the relative increase in trading volumes—which is more prevalent for companies with revenues in excess of $2 billion—wears off the following year. Since most companies don't have a liquidity issue, the rise in trading volumes is neither good nor bad from a shareholder's perspective. Greater volumes merely represent an increased opportunity for short-term traders to act on the news of the earnings guidance and have no lasting relevance for shareholders.

. . . but real costs

Analysts, executives, and investors understand that the practice of offering quarterly earnings guidance can have

[4]We analyzed companies by size—small ($500 million to $2 billion), medium ($2 billion to $5 billion), and large (greater than $5 billion)—and by industry, including consumer packaged goods and pharmaceuticals.

[5]Excess returns in this case are defined as the TRS of a company issuing guidance minus the median TRS of companies in the same industry not issuing guidance.

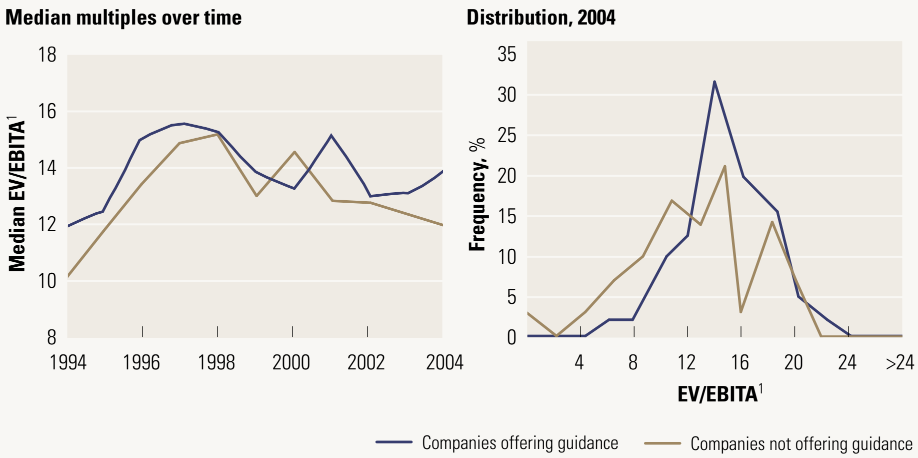
[6]Although increases in volatility were larger than decreases among small and midsize companies, the sample was too small to warrant stronger conclusions.

[7]We determined the relative effect by comparing a trading-volume index for the guiding company to the median index for nonguiding ones in the same sector. The index was created by dividing the trading volume in the year guidance started (normalized by shares outstanding) by the trading volume in the previous year.

EXHIBIT 2

No impact on multiples

For companies in consumer-packaged-goods sector



[1] EV = enterprise value; EBITA = earnings before interest, taxes, and amortization.
Source: Thomson; McKinsey analysis

intangible costs and unfortunate, unintended consequences. The difficulty of predicting earnings accurately, for example, can lead to the often painful result of missing quarterly forecasts. That, in turn, can be a powerful incentive for management to focus excessive attention on the short term; to sacrifice longer-term, value-creating investments in favor of short-term results; and, in some cases, to manage earnings inappropriately from quarter to quarter to create the illusion of stability.

The practice also bears hard costs. In our survey, executives ranked the demands on management's time as the biggest cost of issuing frequent guidance, followed closely by the indirect cost of an excessively short-term focus. Respondents also cited demands on employees as a cost.

The risks of not providing earnings guidance

Of course, some investors would say that *not* issuing guidance can have real costs as well. On February 1 of this year, Google, the Internet search engine highflier, saw its shares tumble by 7 percent when its fourth-quarter results fell short of the lofty expectations bandied about in the days leading up to the release. Some investors blamed the sell-off on Google's refusal to issue guidance that might have kept expectations in check.

Still, while most companies do offer quarterly guidance, a number of respected and highly visible companies have announced that they will either minimize the practice—offering only annual guidance—or abandon it altogether in favor of longer-range indications of their strategy and business conditions. In January 2006 alone, for example, Citigroup and Motorola announced that they would move away from quarterly earnings guidance, and Intel, asserting that "updates were *increasingly irrelevant* to managing the company's long-term growth," announced that it would end its midquarter updates on sales and profit margins.

But many companies that currently offer guidance are reluctant to stop: in our survey, executives at 83 percent of them said that they had no plans to change their programs. These executives indicated that they fear the potential for increased share price volatility upon the release of earnings data, as well as the possibility of a decrease in share prices, if guidance were discontinued. The executives also worry that discontinuing guidance will make their companies less visible to investors and analysts.

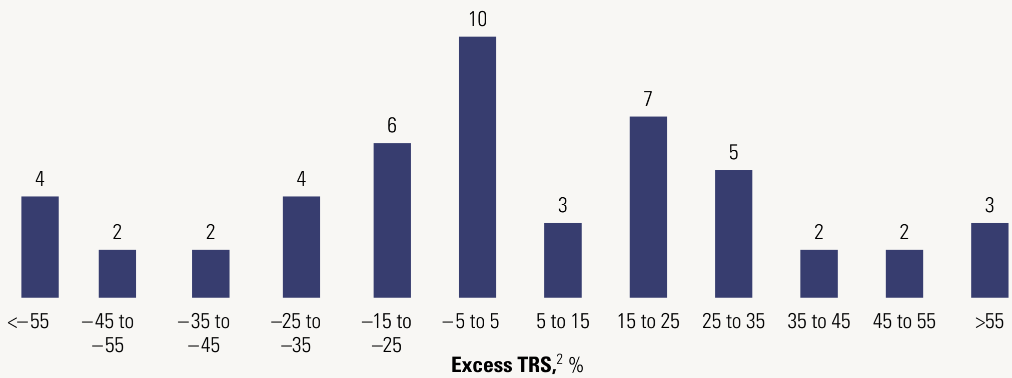
But when we analyzed 126 companies that discontinued guidance, we found that they were nearly as likely to see higher as lower TRS, compared with the market. Of the 126, 58 had a higher TRS in the year they stopped issuing guidance, and 68 had a lower TRS compared with the

EXHIBIT 3

Little benefit to shareholders

Number of companies[1]

Excess total returns to shareholders (TRS) in the year that companies begin offering guidance



[1] 50 companies in guidance sample, all from consumer-packaged-goods sector.
[2] Excess TRS for a company is defined as TRS in year guidance began minus median TRS in the same year for companies not offering guidance.
Source: Thomson; McKinsey analysis

overall market. Furthermore, our analysis showed that the lower-than-market TRS of companies that discontinued guidance resulted from poor underlying performance and not the act of ending guidance itself (Exhibit 4). In our sample of 126 companies that stopped issuing guidance, 79 did so as their return on invested capital was already declining, 47 while their ROIC was rising. Of the former group, 50 experienced a lower TRS than the market, while 29 had a higher one.[8] Among those companies with a rising ROIC, only 18 had a lower TRS than the market, demonstrating that the lower TRS was correlated with a falling ROIC. Last, academic research[9] also shows that ending guidance doesn't lead to reduced coverage or increased volatility and concludes that the negative shareholder returns of companies discontinuing guidance are the result of poor expectations for future performance and of the decreased accuracy of forecasts after guidance stopped.

To guide or not to guide?

With scant evidence of any shareholder benefits to be gained from providing frequent earnings guidance but clear evidence of increased costs, managers should consider whether there is a better way to communicate with analysts and investors.

We believe there is. Instead of providing frequent earnings guidance, companies can help the market to understand their business, the underlying value drivers, the expected business climate, and their strategy—in short, to understand their long-term health as well as their short-term performance. Analysts and investors would then be better equipped to forecast the financial performance of these companies and to reach conclusions about their value.

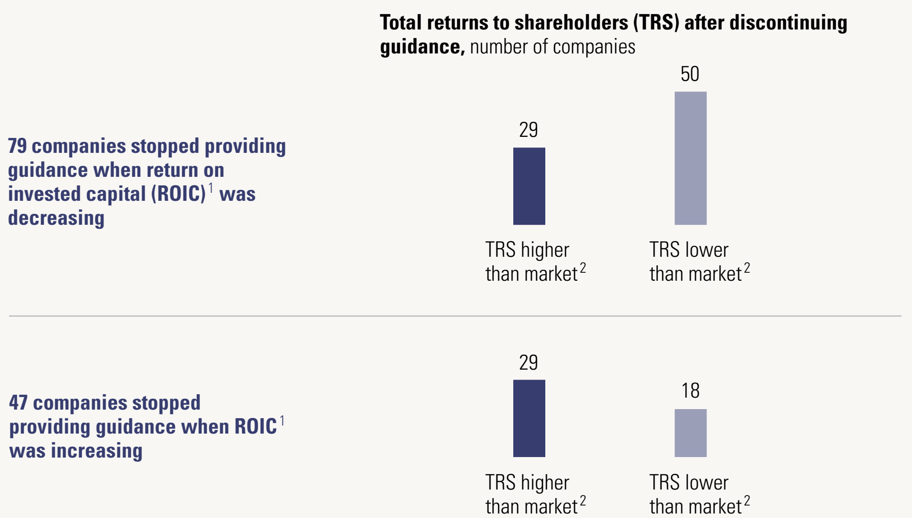
A retailing company, for example, could provide the components of revenue growth (same- and new-store sales growth, volumes,

[8] Compared with the market in the year that guidance was stopped.

[9] Shuping Chen, Dawn A. Matsumoto, and Shivaram Rajgopal, "Is silence golden? An empirical analysis of firms that stop giving quarterly earnings guidance," University of Washington working paper, January 2006 (http://papers.ssrn.com).

EXHIBIT 4

A matter of performance



[1]Average 2-year ROIC before starting guidance compared with average 2-year ROIC after starting guidance.
[2]Compared to S&P 500 index.
Source: Thomson; McKinsey analysis

prices, product mix, and currency effect) and margins by business unit. It could highlight the factors that drive volume growth (disposable income, marketing expenditures, weather patterns), margins (input costs, trade spending, corporate costs), and capital intensity (the number, age, and location of its stores and the efficiency of its working capital) and explain how these factors will likely change in the future. In addition, the company could disclose the drivers of its recent performance as well as management's expectations for the future. Analysts could then build their own models to predict earnings going forward. Moreover, they would be better able to determine the impact of various corporate moves—for example, cost cutting, share repurchases, marketing expenditures, R&D, organic-growth initiatives, and M&A—not only on earnings but also, more important, on value.

Our approach has the additional advantage of reducing intangible costs. When Coca-Cola stopped issuing guidance, in late 2002, its executives had concluded that providing short-term results actually *prevented* management from focusing meaningfully on strategic initiatives to build its business and succeed over the long term. Instead of indicating weak earnings, Gary Fayard (who was then CFO) believed that the move signaled a renewed focus on long-term goals. The market seemed to agree and did not react negatively, holding Coke's share price steady.[10] Like Coke, companies that reduce or discontinue guidance must clearly indicate that poor expectations of future performance are not the reason.

The voluntary disclosure of financial information is a key component of high-functioning capital markets. The current trend—more and more companies discontinuing quarterly guidance and substituting thoughtful disclosures about their long-range strategy and business fundamentals—is a healthy one. In this way, companies will better signal their commitment to creating long-term, sustainable shareholder value and encourage their investors to adopt a similar outlook. **MoF**

[10]See, for example, David M. Katz, "Nothing but the real thing," CFO.com, March 2003.

Peggy Hsieh (Peggy_Hsieh@McKinsey.com) and **S. R. Rajan** (SR_Rajan@McKinsey.com) are consultants in McKinsey's New York office, where **Tim Koller** (Tim_Koller@McKinsey.com) is a partner.

Balancing ROIC and growth to **build value**

Companies find growth enticing, but a strong return on invested capital is more sustainable.

Bing Cao, Bin Jiang, and Timothy Koller

Growth might be the lifeblood of a business, but it isn't always the best or most sustainable way to create value for shareholders. Return on invested capital (ROIC) is often just as important—and occasionally even more so—as a measure of value creation and can be easier to sustain at a high level.

When a company's ROIC is already high, growth typically generates additional value. But if a company's ROIC is low, executives can create more value by boosting ROIC than by pursuing growth (Exhibit 1). A close look at companies with high price-to-earnings multiples shows that many have extraordinary returns on capital but limited growth. This scrutiny suggests that, contrary to conventional wisdom, investors recognize (and will pay more for) the anticipated returns of companies with a strong ROIC, despite their limited growth prospects. This observation doesn't mean that growth is undesirable; unless companies keep up with their industries, they will likely destroy value. But they shouldn't pursue growth heroically at the expense of improvements in ROIC.

After identifying the largest publicly listed companies in the United States (by revenues) in 1965, 1975, 1985, and 1995, we examined their long-term patterns of growth and ROIC.[1] The median ROIC for the 1965 group remained stable, at about 9 percent, over the next 40 years. We observed the same pattern for the groups from 1975, 1985, and 1995. In other words, ROIC tends to remain stable over time (Exhibit 2).

Growth, by contrast, is fleeting. The median inflation-adjusted growth in revenues for the top 500 companies in 1965 started out at 7 percent and steadily declined to 2 percent over the next 10 years, hitting a cyclical low of 0 percent by year 17. For the next 20 years, growth hovered at around 2 percent—a figure below the level of US GDP growth.[2] We observed a similar general pattern of decay in median real growth for the top 500 companies in 1975, 1985, and 1995.

Moreover, pattern analysis at the industry[3] level further shows the importance of managing ROIC. A comparison of ROIC[4] for the top 500 companies of 1965 shows that it remained steady in most sectors and even increased in some—particularly those with strong brands or patent-protected products (household and personal goods, for example) and pharmaceuticals and biotechnology (Exhibit 3, part 1). Growth, by contrast, almost always declined, except in pharmaceuticals (Exhibit 3, part 2).

A close look at individual companies finds similar patterns; companies with high levels of ROIC tend to hold on to that advantage, whereas high-growth companies rarely do. Exhibit 4 looks at the probability that a company will migrate from one level of ROIC to another over the course of a decade. A company that generated an ROIC of less than 5 percent in 1994, for instance, had a 43 percent chance of earning less than 5 percent in 2003. As the exhibit shows, low and high performers alike demonstrate consistency throughout the 40-year period. Companies with an ROIC of 5 to 10 percent had a 40 percent probability of remaining in

(continued on page 16)

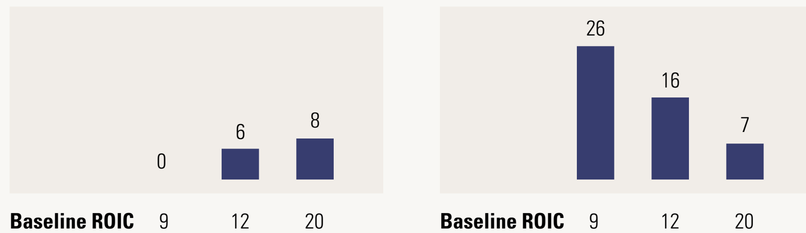
[1] The performance of each set of companies was tracked as a portfolio until 2004.
[2] Real GDP growth averaged around 2.5 to 3.5 percent a year from 1929 to 2005.
[3] Defined by the Global Industry Classification Standard (GICS).
[4] Measured by the median ROIC of companies that survived in subsequent years.

EXHIBIT 1

Value, compared

Improving returns on invested capital creates more value than growth (except when ROIC is already high).

Value created by 1% faster growth,[1] % **Value created by 1% higher ROIC,[1] %**



[1]Assumes 9% weighted average cost of capital.

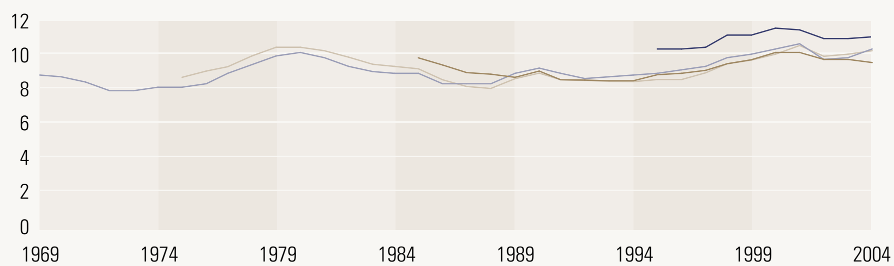
EXHIBIT 2

A more sustainable measure

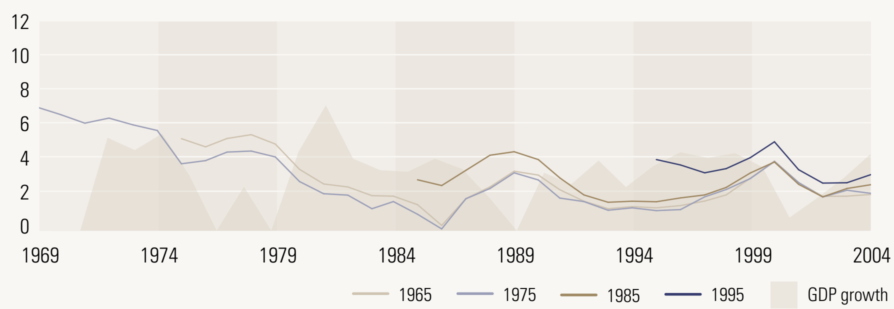
Median for top 500 publicly listed US companies by revenues in 1965, 1975, 1985, and 1995

Returns on invested capital (ROIC) is sustainable over time, but growth inevitably declines.

ROIC,[1] %



Real revenue growth,[1] %



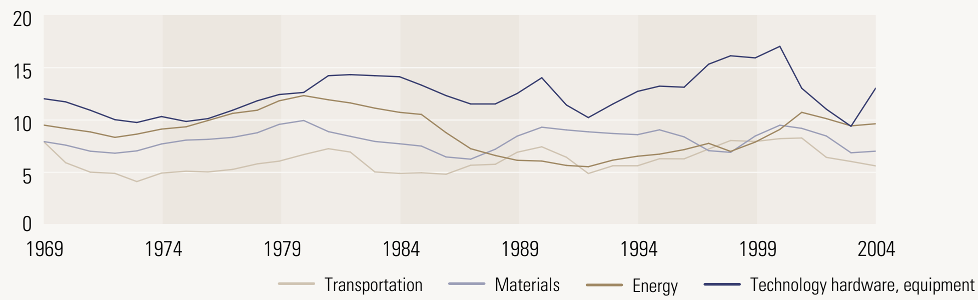
[1]ROIC shown is 7-year simple average, including goodwill; growth shown is 7-year compound annual growth rate for revenues adjusted for inflation.

EXHIBIT 3: Part 1

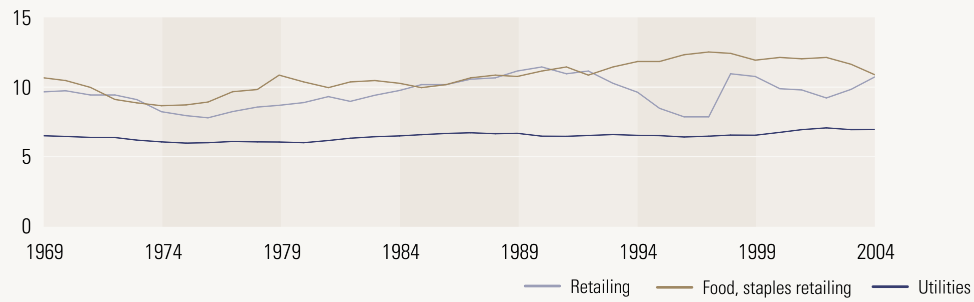
Industry variations in ROIC

Top 500 publicly listed US companies by revenues, 1965 portfolio, ROIC by industry,[1] %

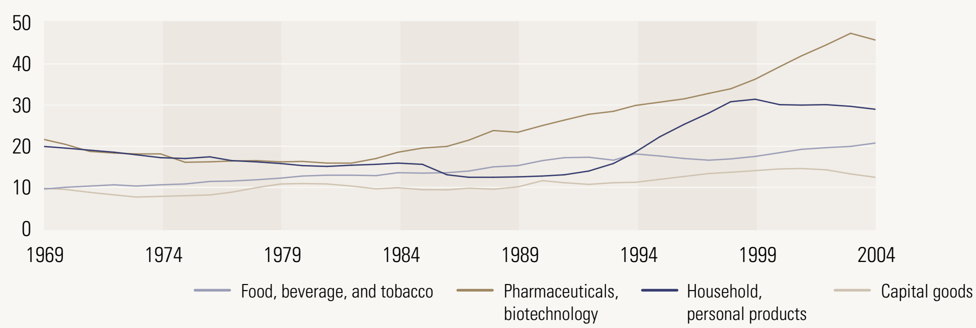
4 sectors saw averages fluctuating cyclically, within an industry-specific tight range.



3 had remarkably stable returns.



4 saw averages improve.



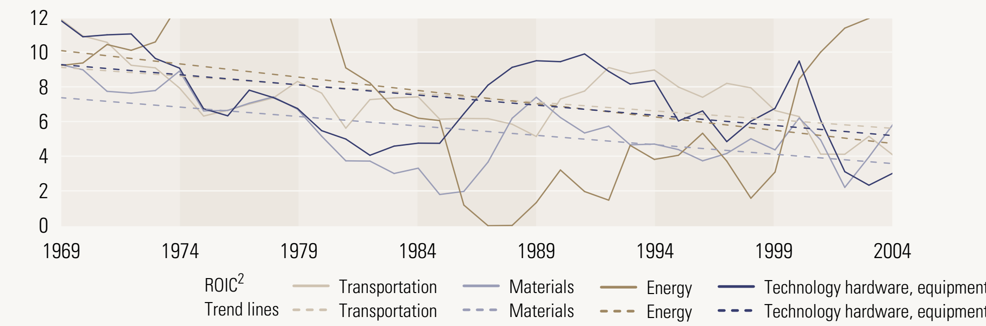
[1]Industries defined by Global Industry Classification Standard (GICS); excludes sectors with <5 companies in 2004; portfolios for 1975, 1985, and 1995 display similar patterns.

EXHIBIT 3: Part 2

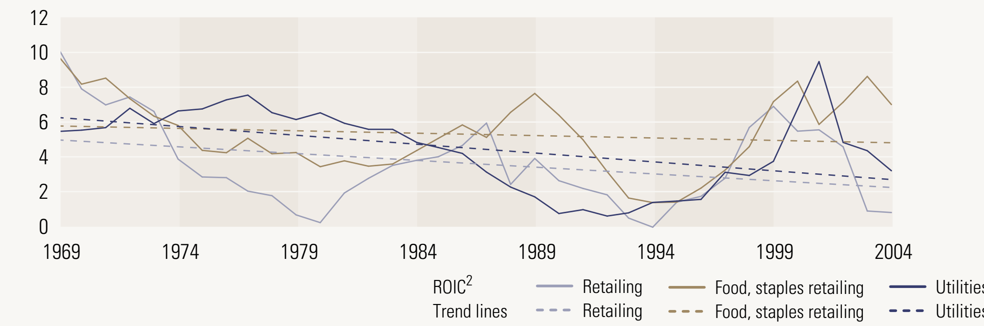
Industry variations in growth

Top 500 publicly listed US companies by revenues, 1965 portfolio, growth by industry,[1] %

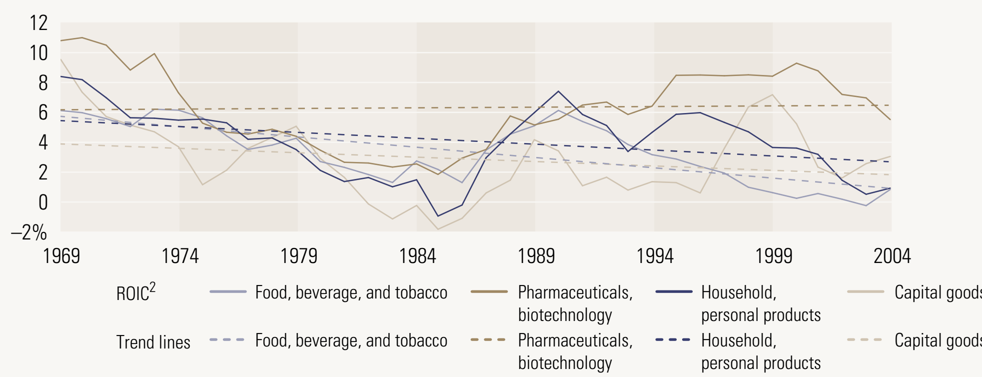
But there is no escape from a decline in growth for cyclical sectors . . .



. . . and stable sectors.



The pharmaceuticals sector is the only apparent exception.



[1]Industry defined by Global Industry Classification Standard (GICS); excludes sectors with <5 companies in 2004; portfolios for 1975, 1985, and 1995 display similar patterns.
[2]Return on invested capital.

EXHIBIT 4

Individual companies can sustain a high ROIC . . .

3-year average ROIC, without goodwill, of all publicly listed US companies with real revenues >$200 million, %

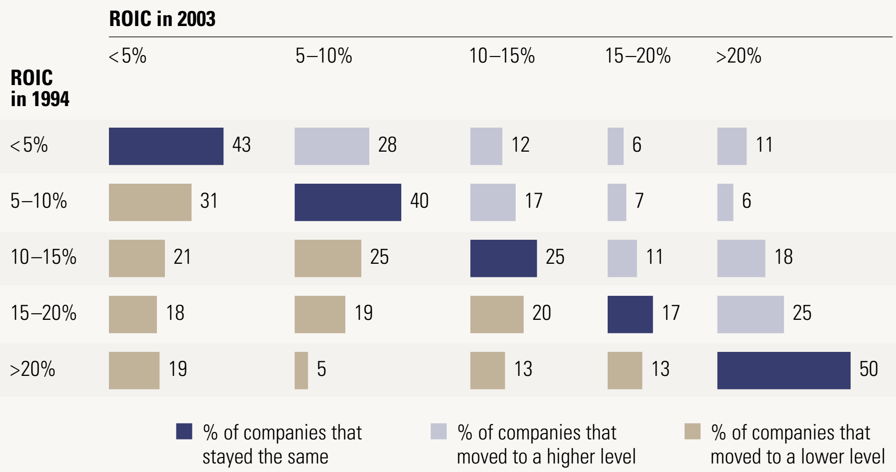
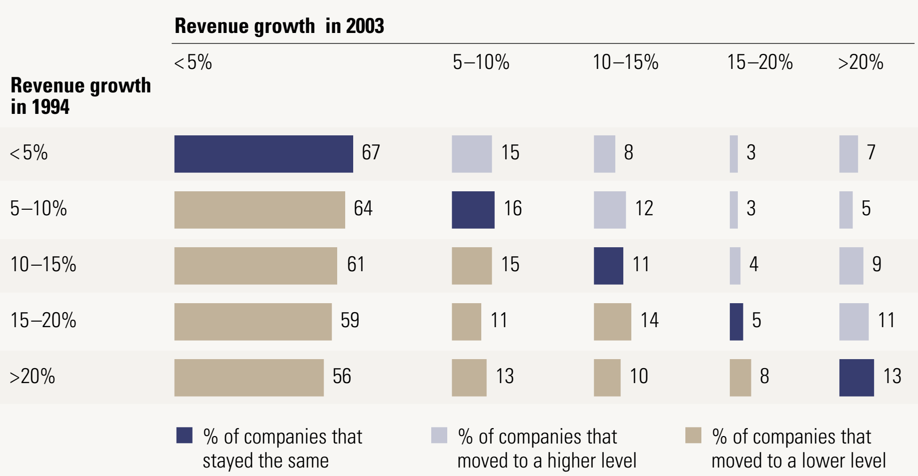


EXHIBIT 5

. . . but cannot sustain growth

3-year compound annual growth rate of real revenues of all publicly listed US companies with real revenues >$200 million, %



the same group ten years later; companies with an ROIC of more than 20 percent had a 50 percent probability.

But when it comes to growth, companies are very likely to experience substantial declines (Exhibit 5). Of companies that grew by more than 20 percent in 1994, for example, 56 percent were growing at real rates of less than 5 percent ten years later. Only 13 percent of the high-growth companies maintained 20 percent real growth ten years on, and acquisitions probably drove most of it. **MoF**

Bing Cao (Bing_Cao@McKinsey.com) and **Bin Jiang** (Bin_Jiang@McKinsey.com) are consultants and **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in McKinsey's New York office.

Toward a **leaner** finance department

Borrowing key principles from lean manufacturing can help the finance function to eliminate waste.

Richard Dobbs, Herbert Pohl, and Florian Wolff

Waste never sleeps in the finance department—that bastion of efficiency and cost effectiveness. Consider the reams of finance reports that go unread and the unused forecasts, not to mention duplicate computations of similar data, the endless consolidation of existing reports, and mundane activities such as manually entering data or tailoring the layout of reports.

The impact is significant. In a recent exercise that benchmarked efficiency at consumer goods companies, the best finance function was nine times more productive than the worst (exhibit). Production times also varied widely. Among the largest European companies, for example, it took an average of 100 days after the end of the financial year to publish the annual numbers: the fastest did so in a mere 55 days, while the slowest took nearly 200. This period typically indicates the amount of time a finance department needs to provide executives with reliable data for decision making. In our experience with clients, many of these differences can be explained not by better IT systems or harder work but by the waste that consumes resources. In a manufacturing facility, a manager seeking to address such a problem might learn from the achievements of the lean-manufacturing system pioneered by Toyota Motor in the 1970s. Toyota's concept is based on the systematic elimination of all sources of waste at all levels of an organization.[1] Industries as diverse as retailing, telecommunications, airlines, services, banking, and insurance have adopted parts of this approach in order to achieve improvements in quality and efficiency of 40 to 70 percent.

We have seen finance operations achieve similar results. At one European manufacturing company, for example, the number of reports that the finance department produced fell by a third—and the amount of data it routinely monitored for analysis dropped from nearly 17,000 data points to a much more manageable 400.

Borrowing from lean

In our experience, the finance function eludes any sort of standardized lean approach. Companies routinely have different goals when they introduce the concept, and not every lean tool or principle is equally useful in every situation. We have, however, found three ideas from the lean-manufacturing world that are particularly helpful in eliminating waste and improving efficiency: focusing on external customers, exploiting chain reactions (in other words, resolving one problem reveals others), and drilling down to expose the root causes of problems. These concepts can help companies cut costs, improve efficiency, and begin to move the finance organization toward a mind-set of continuous improvement.

Focusing on external customers

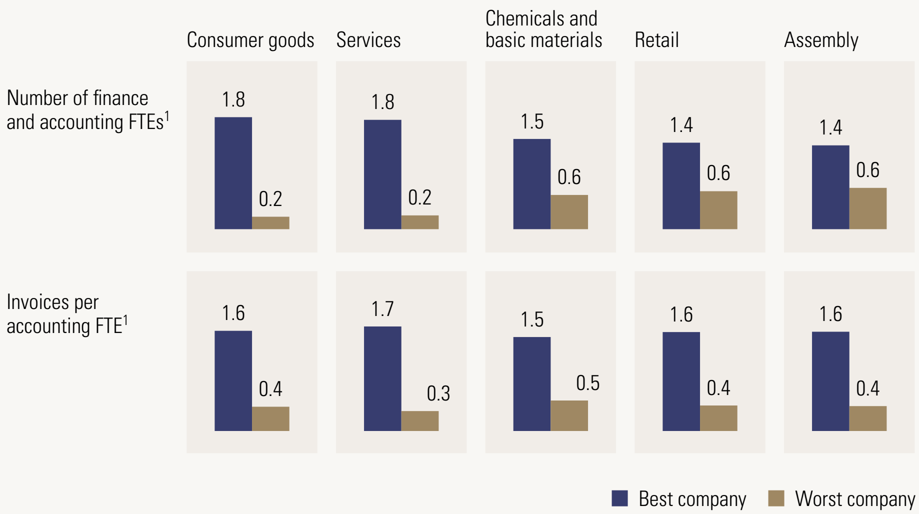
Many finance departments can implement a more efficiency-minded approach by making the external customers of their companies the ultimate referee of which activities add value and which create waste. By contrast, the finance function typically relies on some internal entity to determine which reports are necessary—an approach that often unwittingly produces waste.

[1] Anthony R. Goland, John Hall, and Devereaux A. Clifford, "First National Toyota," *The McKinsey Quarterly,* 1998 Number 4, pp. 58–66 (www.mckinseyquarterly.com/links/21094); and John Drew, Blair McCallum, and Stefan Roggenhofer, *Journey to Lean: Making Operational Change Stick,* Hampshire, England: Palgrave Macmillan, 2004.

EXHIBIT

Considerable variation in efficiency

Index: industry average = 1.0



[1]Full-time equivalents.

Consider, for example, the way one manufacturing company approached its customers to collect on late or delinquent accounts. The sales department claimed that customers were sensitive to reminders and that an overly aggressive approach would sour relations with them. As a result, the sales group allowed the accounting department to approach only a few, mostly smaller customers; for all others, it needed the sales department's explicit approval—which almost never came. The sales department's decisions about which customers could be approached were neither challenged nor regularly reviewed. This arrangement frustrated the accounting managers, and no one would accept responsibility for the number of days when sales outstanding rose above average.

The tension was broken by asking customers what *they* thought. It turned out that they understood perfectly well that the company wanted its money—and were often even grateful to the accounting department for unearthing process problems on their end that delayed payment. When customers were asked about their key criteria for selecting a manufacturing company, the handling of delinquent accounts was never mentioned. The sales department's long-standing concern about losing customers was entirely misplaced.

In the end, the two departments agreed that accounting should provide service for all customers and have the responsibility for the outstanding accounts of most of them. The sales department assumed responsibility for the very few key accounts remaining and agreed to conduct regular reviews of key accounts with the accountants to re-sort the lists.

Better communication between the departments also helped the manufacturing company to reduce the number of reports it produced. The company had observed that once an executive requested a report, it would proceed through production, without any critical assessment of its usefulness. Cutting back on the number of reports posed a challenge, since their sponsors regularly claimed that they were necessary. In response, finance analysts found it effective to talk with a report's sponsor about just how it would serve the needs of end users and to press for concrete examples of the last time such data were used. Some reports survived; others were curtailed. But often, the outcome was to discontinue reports altogether.

Exploiting chain reactions

The value of introducing a more efficiency-focused mind-set isn't always evident from just one step in the process—in fact, the payoff from a single step may be rather disappointing. The real power is cumulative, for a single initiative frequently exposes deeper problems that, once addressed, lead to a more comprehensive solution.

At another manufacturing company, for example, the accounting department followed one small initiative with others that ultimately generated cost savings of 60 percent. This department had entered the expenses for a foreign subsidiary's transportation services under the heading "other indirect costs" and then applied the daily exchange rate to translate these figures into euros. This approach created two problems. First, the parent company's consolidation program broke down transportation costs individually, but the subsidiary's costs were buried in a single generic line item, so detail was lost. Also, the consolidation software used an average monthly exchange rate to translate foreign currencies, so even if the data had been available, the numbers wouldn't have matched those at the subsidiary.

Resolving those specific problems for just a single subsidiary would have been an improvement. But this initiative also revealed that almost all line items were plagued by issues, which created substantial waste when controllers later tried to analyze the company's performance and to reconcile the numbers. The effort's real power became clear as the company implemented a combination of later initiatives—which included standardizing the chart of accounts, setting clear principles for the treatment of currencies, and establishing governance systems—to ensure that the changes would last. The company also readjusted its IT systems, which turned out to be the easiest step to implement.

Drilling down to root causes

No matter what problem an organization faces, the finance function's default answer is often to add a new system or data warehouse to deal with complexity and increase efficiency. While such moves may indeed help companies deal with difficult situations, they seldom tackle the real issues. The experience of one company in the services industry—let's call it ServiceCo—illustrates the circuitous route that problem solving takes.

Everyone involved in budgeting at ServiceCo complained about the endless loops in the process and the poor quality of the data in budget proposals. Indeed, the first bottom-up proposals didn't meet even fundamental quality checks, let alone the target budget goals. The process added so little value that some argued it was scarcely worth the effort.

Desperate for improvement, ServiceCo's CFO first requested a new budgeting tool to streamline the process and a data warehouse to hold all relevant information. He also tried to enforce deadlines, to provide additional templates as a way of creating more structure, and to shorten the time frame for developing certain elements of the budget. While these moves did compress the schedule, quality remained low. Since the responsibility for different parts of the budget was poorly defined, reports still had to be circulated among various departments to align overlapping analyses. Also, ServiceCo's approach to budgeting focused on the profit-and-loss statement of each function, business, and region, so the company got a fragmented view of the budget as each function translated the figures back into its own key performance indicator (KPI) using its own definitions.

To address these problems, ServiceCo's managers agreed on a single budgeting language, which also clearly defined who was responsible for which parts of the budget—an added benefit. But focusing the budget dialogue on the KPIs still didn't get to the root problem: middle management and the controller's office received little direction from top management and were implicitly left to clarify the company's strategic direction themselves. The result was a muddled strategy with no clear connection to the numbers in the budget. Instead of having each unit establish and define its own KPIs and only then aligning strategic plans, top management needed to link the KPIs to the company's strategic direction from the beginning.

Getting to the root cause of so many problems earlier could have saved the company a lot of grief. Once ServiceCo's board and middle management determined the right KPIs, the strategic direction and the budget assumptions were set in less than half a day, which enabled the controller's office and middle management to specify the assumptions behind the budget quickly. The management team did spend more time discussing the company's strategic direction, but that time was well spent. The result was a more streamlined process that reduced the much-despised loops in the process, established clear assumptions for the KPIs up front, and defined each function's business solution space more tightly. The budget was finalized quickly.

Getting started

It takes time to introduce lean-manufacturing principles to a finance function—four to six months to make them stick in individual units and two to three years on an organizational level. A new mind-set and new capabilities are needed as well, and the effort won't be universally appreciated, at least in the beginning.

Integration tools can be borrowed: in particular, a value stream map can help managers document an entire accounting process end to end and thus illuminate various types of waste, much as it would in manufacturing. Every activity should be examined to see whether it truly contributes value—and to see how that value could be added in other ways. Checking the quality of data, for example, certainly adds value, but the real issue is generating relevant, high-quality data in the first place. The same kind of analysis can be applied to almost any process, including budgeting, the production of management reports, forecasting, and the preparation of tax statements. In our experience, such an analysis shows that controllers spend only a fraction of their time on activities that really add value.

The challenge in developing value stream maps, as one European company found, is striking a balance between including the degree of detail needed for high-level analysis and keeping the resulting process manual to a manageable length. Unlike a 6-page document of summaries or a 5,000-page tome, a complete desk-by-desk description of the process, with some high-level perspective, is useful. So too is a mind-set that challenges one assumption after another.

Ultimately, a leaner finance function will reduce costs, increase quality, and better align corporate responsibilities, both within the finance function and between finance and other departments. These steps can create a virtuous cycle of waste reduction. MoF

Richard Dobbs (Richard_Dobbs@McKinsey.com) is a partner in McKinsey's London office, and **Herbert Pohl** (Herbert_Pohl@McKinsey.com) is a partner in the Munich office, where **Florian Wolff** (Florian_Wolff@McKinsey.com) is an associate principal.

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