Is a Lack of Financial Acumen Putting Your Company at Risk?

By Massimo Massa , INSEAD

The owners and directors on your company's board may be skilled in foresight and implementing strategy but are they financially astute enough to understand the risk?

Finance is not just about the ability to work numbers, it's having the mindset to solve problems and understand the implication of strategies in terms of value creation and risk.

Traditionally, finance has been considered a technical part of running a company. Owners and directors have worked under the assumption it is a tool, a task, that can be delegated to the CFOs. The reality is that financial acumen is a critical element of value creation within a company. In fact, it's probably the most important element as it gives owners and directors the ability to understand what type of risk revenue or risk/return trade-off they face.

Quantifying the risk/return trade-off

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Ignorance – or lack of understanding – of this concept of finance at board level has been widespread not only in industrial and manufacturing sectors but among top players in the financial industry. The global financial crisis is evidence that the CEOs and board members of banking and insurance conglomerates were not clearly quantifying the risk/return trade-off on decisions they were backing, resulting in positions being taken that not only stymied value creation but in many cases led companies on a path to bankruptcy.

To implement better strategies it is critical that board members and owners understand the financial implication of what they are doing.

While it is possible to have many strategies to create value, and there may be an infinite number of positive solutions for a company, finance is the only way to quantify what the value creation of each actually is. Some strategies may increase profits, some may generate a bigger slice of the market share but at the same time they may completely destroy value because leaders don't account for one critical factor – risk. It is finance that provides the ability and understanding of quantifying this risk and teasing out first order effect from second order effect when assessing true value.

Understanding the framework of value creation

A certain degree of financial acumen is vital for all owners and board members to understand the framework of value creation and the risk/return trade-off involved. Effectively, it is a way of aligning and understanding the main driving force of value creation and, importantly, providing a hierarchy of objectives goals and a mission for the company.

Understanding the framework of value creation from a financial perspective and understanding finance as a tool to implement it are two very different concepts. Having a deep understanding of the definitive data on financial transactions is an expertise that some board members should possess, just as some should specialise in strategy and others in marketing – it is commonly understood that a good board is one made up of an array of diverse talents.

But a mental framework of value creation has to be understood by every board member otherwise it would be impossible to evaluate or understand a value proposition.

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You could ask the question “is it necessary for everyone on a multinational board to be fluent in English?” While it’s not necessary for all members to write poetry in English, they must be all be conversant in the language. Similarly, the mental value creating framework is something every board member should know. It provides a means of communicating and setting the frame to brainstorm and solve problems. By understanding the financial implication of what they’re doing, directors and owners are better able to introduce strategies. By working from the same financial framework, board members will speak the same jargon and be better able to understand and communicate with each other.

The best boards are the ones in which everyone is fine-tuned and sitting at the same table.

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