The New CFO Financial Leadership Manual

Second Edition

Steven M. Bragg

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Electrician, locksmith, and woodworker, the first in the family to finish college, an indisputable genius, and our provider—I would not be where I am without you, Dad. But couldn't you let me win at Scrabble just once?

CONTENTS

PREFACE

The second edition of the *New CFO Financial Leadership Manual* is designed to give the Chief Financial Officer (CFO) a complete overview of his or her place in the corporation, and to provide strategies for how to handle strategic decisions related to a variety of financial, tax, and information technology issues. Some of the questions that Chapters 1 through 4 answer include:

- What should I do during my first days on the job?
- What are my specific responsibilities?
- How do I reduce my foreign currency exposure?
- How do I increase the company's return on assets?
- When should I issue convertible securities?
- What factors should I consider in regard to a step costing decision?
- When can I use net operating loss tax carryforwards?
- How do I decide which products to eliminate?
- How can I use transfer pricing to reduce income taxes?
- What specific information technologies should I install for a certain type of business, such as a low-cost producer or rapid product innovator?

The CFO must also become involved in a variety of accounting topics, though not at the transactional level of detail with which a controller will be occupied. Key areas of concern are the development and maintenance of performance measurement and control systems. The CFO must also interact with the internal and external auditors, while also (if the company is publicly held) making regular reports to the Securities and Exchange Commission (SEC). Chapters 5 through 8 address these topics, and yield answers to all of the following questions, as well as many more:

- How do I set up a performance measurement system?
- What are the best performance measurements to install for tracking a variety of accounting and financial issues?
- What types of fraud can be committed, and what kinds of controls can reduce their likelihood of occurrence?
- Which key controls should I install?
- How do I identify and eliminate unnecessary controls?
- What is the impact of Sarbanes-Oxley on my company?
- Who serves on the audit committee, and what is its role?
- How do I deal with the external and internal auditors?
- Which reports do I file with the SEC, and what information should I include in them?

One of the CFO's primary tasks is the analysis of a wide range of financial issues, resulting in recommendations for action to the management team. Chapters 9 through 11 address such topics as the cost of capital, capital budgeting, risk analysis, capacity utilization, and breakeven. With these chapters in hand, one can answer the following questions:

- How do I calculate my company's cost of capital?
- How can I modify the cost of capital to increase shareholder value?
- What are the various methods for determining the value of proposed capital projects?
- How do I calculate net present value, the internal rate of return, and the payback period?
- How do I allocate funding to research and development projects?
- How do I determine capacity utilization, and what decisions can I make with this information?
- How can breakeven analysis be used to optimize profitability?

A CFO is sometimes given the primary task of obtaining funding, leaving all other activities up to the controller or treasurer. In this role, the CFO must know how to manage existing cash flows, invest excess funds, obtain both debt and equity financing, conduct an initial public offering, and take a company private. These topics are addressed by Chapters 12 through 17, which provide answers to all of the following questions, and more:

- How do I construct a cash forecasting model and measure its accuracy?
- How do I control cash flows?
- How do I construct natural hedges?
- What investment restrictions should I recommend to the Board of Directors?
- What are good short-term investment options?
- What is the role of credit rating agencies?
- What are the various types of available debt financing?
- How do I conduct a private placement of stock?
- How do I arrange a private investment in public equity?
- What information goes into an offering memorandum?
- How do I place a value on offered stock?
- Which steps do I follow to complete an initial public offering?
- How do I create a reverse merger?
- Why are companies using the Alternative Investment Market as their stock exchange of choice?
- How do I file with the SEC to take a company private?

Though a CFO can certainly be of great value to a company by properly managing its flow of funds, there are also a number of management areas in which he or she can enhance operations. These are addressed in Chapters 18 through 22, which discuss risk management, outsourcing, operational best practices, mergers and acquisitions, and electronic commerce. By perusing them, one can find answers to the following questions:

- How do I engage in risk planning?

- What types of company-wide policies and procedures should I install to mitigate risks?
- How do I evaluate insurance carriers?
- What are the advantages and disadvantages of outsourcing various aspects of the accounting and finance functions, and which contractual and transitional issues should I be aware of?
- What are some of the best practices I can implement in the accounting and finance functions to improve their efficiency?
- How do I evaluate acquisition targets?
- How do I place a value on an acquisition target?
- How do I value prospective synergies resulting from an acquisition?
- How does the e-commerce business model work, and how do I restructure the business to incorporate it?

There are also several topics that may require some degree of expertise by the CFO from time to time. One is employee compensation, which is addressed in Chapter 23. It covers such topics as deferred compensation, life insurance, stock appreciation rights, stock options, and the bonus sliding scale. One issue that a CFO certainly hopes never to experience is bankruptcy, which is described in Chapter 24. This chapter describes the sequence of events in a typical bankruptcy proceeding, as well as special bankruptcy rules, payment priorities, the parties that typically become involved in the process, and the impact of the Bankruptcy Act of 2005.

The CFO may also require checklists to perform certain aspects of the job. Toward this end, Appendix A contains a checklist that itemizes the usual priority of action items required during the first days of fitting into a new CFO position. Appendix B contains a summary-level list of performance measurements that are useful as a reference for those CFOs who are constructing performance measurement systems. Finally, Appendix C contains an extensive due diligence checklist that is most helpful for reviewing the operations of a potential acquisition candidate.

In total, this book is a comprehensive guidebook for the CFO who needs an overview of strategies, measurement and control systems, financial analysis tools, funding sources, and management improvement tips that will help provide the greatest possible value to the company. If you have any comments about this book, or would like to see additional chapters added in future editions, contact the author at bragg.steven@gmail.com. Thank you!

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Centennial, Colorado
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The real work of preparing a book for publication begins only after the rough manuscript appears at the publisher's doorstep. It is generally greeted with gasps of dismay by the group of editors who must review it in more detail than I ever did, working through several colored correction pencils to achieve a version that will not be immediately rejected with snorts of derision by the reading public. Thank you for making all the corrections that turn my words into a smoothly flowing and intelligible document.

ABOUT THE AUTHOR

Steven Bragg, CPA, CMA, CIA, CPM, CPIM, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young and auditor at Deloitte & Touche. He received a master's degree in Finance from Bentley College, an MBA from Babson College, and a bachelor's degree in Economics from the University of Maine. He has been the two-time president of the Colorado Mountain Club and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books published by John Wiley & Sons:

Accounting and Finance for Your Small Business
Accounting Best Practices
Accounting Control Best Practices
Accounting Reference Desktop
Billing and Collections Best Practices
Business Ratios and Formulas
Controller's Guide to Costing
Controller's Guide to Planning and Controlling Operations
Controller's Guide: Roles and Responsibilities for the New Controller
Controllership
Cost Accounting
Design and Maintenance of Accounting Manuals
Essentials of Payroll
Fast Close
Financial Analysis
GAAP Guide
GAAP Implementation Guide
Inventory Accounting
Inventory Best Practices
Just-in-Time Accounting
Managing Explosive Corporate Growth
Outsourcing
Payroll Accounting
Payroll Best Practices
Sales and Operations for Your Small Business
Throughput Accounting
The Controller's Function
The New CFO Financial Leadership Manual
The Ultimate Accountants' Reference

Other titles by Mr. Bragg include:

Advanced Accounting Systems (Institute of Internal Auditors)
Run the Rockies (CMC Press)

Free On-Line Resources by Steve Bragg
Steve issues a free bimonthly accounting best practices newsletter, as well as an accounting best practices podcast. You can sign up for free delivery of the newsletter and/or podcast (also available through iTunes) at www.stevebragg.com.

PART 1

OVERVIEW

CHAPTER 1

CFO'S PLACE IN THE CORPORATION

Years ago, Chief Executive Officers (CEOs) were satisfied with finance chiefs who could manage Wall Street analysts, implement financial controls, manage initial public offerings (IPOs), and communicate with the Board of Directors—who, in short, possessed strong financial skills. However, in today's business environment, the ability to change quickly has become a necessity for growth, if not for survival. CEOs are no longer satisfied with financial acumen from their CFOs. They are demanding more from their finance chiefs, looking instead for people who can fill a multitude of roles: business partner, strategic visionary, communicator, confidant, and creator of value. This chapter addresses the place of the CFO in the corporation, describing how to fit into this new and expanded role.

FIRST DAYS IN THE POSITION

You have just been hired into the CFO position and have arrived at the offices of your new company. What do you do? Though it is certainly impressive (to you) to barge in like Napoleon, you may want to consider a different approach that will calm down your new subordinates as well as make them feel that you are someone they can work with. Here are some suggestions for how to handle the critical first few days on the job:

- *Meet with employees.* This is the number-one activity by far. Determine who the key people in the organization are and block out lots of time to meet with them. This certainly includes the entire management team, but it is even better to build relationships far down into the corporate ranks. Get to know the warehouse manager, the purchasing staff, salespeople, and engineers. Always ask who else you should talk to in order to obtain a broad-based view of the company and its problems and strengths. By establishing and maintaining these linkages, you will have great sources of information that circumvent the usual communication channels.
- *Do not review paperwork.* Though you may be tempted to lock yourself up in an office and pore through management reports and statistics, meeting people is the top priority. Save this task for after hours and weekends, when there is no one on hand to meet with.
- *Wait before making major decisions.* The first few months on the job are your assigned "honeymoon period," where the staff will be most accepting of you. Do not shorten the period by making ill-considered decisions. The best approach is to come up with possible solutions, sleep on them, and discuss them with key staff before making any announcements that would be hard to retract.
- *Set priorities.* As a result of your meetings, compile an initial list of work priorities, which should include both efficiency improvements and any needed

departmental restructurings. You can communicate these general targets in group meetings, while revealing individual impacts on employees in one-on-one meetings. Do not let individual employees be personally surprised by your announcements at general staff meetings—always reveal individual impacts *prior to* general meetings, so these people will be prepared.

- *Create and implement a personnel review system.* If you intend to let people go, early in your term is the time to do it. However, there is great risk of letting strong performers go if you do not have adequate information about them, so install a personnel review system as soon as possible and use it to determine who stays and who leaves.

The general guidelines noted here have a heavy emphasis on communication, because employees will be understandably nervous when the boss changes, and you can do a great deal to assuage those feelings. Also, setting up personal contacts throughout the organization is a great way to firmly insert yourself into the organization in short order and makes it much less likely that you will be rejected by the organization at large.

SPECIFIC CFO RESPONSIBILITIES

We have discussed how to structure the workday during the CFO's initial hiring period, but what does the CFO work on? What are the primary tasks to pursue? These targets will vary by company, depending on its revenue, its industry, its funding requirements, and the strategic intentions of its management team. Thus, the CFO will find that entirely different priorities will apply to individual companies. Nonetheless, some of the most common CFO responsibilities are:

- *Pursue shareholder value.* The usual top priority for the CFO is the relentless pursuit of the strategy that has the best chance of increasing the return to shareholders. This also includes a wide range of tactical implementation issues designed to reduce costs.
- *Construct reliable control systems.* A continuing fear of the CFO is that a missing control will result in problems that detrimentally impact the corporation's financial results. A sufficiently large control problem can quite possibly lead to the CFO's termination, so a continuing effort to examine existing systems for control problems is a primary CFO task. This also means that the CFO should be deeply involved in the design of controls for new systems, so they go on-line with adequate controls already in place. The CFO typically uses the internal audit staff to assist in uncovering control problems.
- *Understand and mitigate risk.* This is a major area of concern to the CFO, who is responsible for having a sufficiently in-depth knowledge of company systems to ferret out any risks occurring in a variety of areas, determining their materiality and likelihood of occurrence, and creating and monitoring risk mitigation strategies to keep them from seriously impacting the company. The focus on risk should include some or all of the following areas:

    — *Loss of key business partners.* If a key supplier or customer goes away, how does this impact the company? The CFO can mitigate this risk by lining up alternate sources of supply, as well as by spreading sales to a wider range of customers.

— *Loss of brand image.* What if serious quality or image problems impact a company's key branded product? The CFO can mitigate this risk by implementing a strong focus on rapid management reactions to any brand-related problems, creating strategies in advance for how the company will respond to certain issues, and creating a strong emphasis on brand quality.

— *Product design errors.* What if a design flaw in a product injures a customer, or results in a failed product? The CFO can create rapid-response teams with preconfigured action lists to respond to potential design errors. There should also be product design review teams in place whose review methodologies reduce the chance of a flawed product being released. The CFO should also have a product recall strategy in place, as well as sufficient insurance to cover any remaining risk of loss from this problem.

— *Commodity price changes.* This can involve price increases from suppliers or price declines caused by sales of commodity items to customers. In either case, the CFO's options include the use of long-term fixed-price contracts, as well as a search for alternative materials (for suppliers) or cost cutting to retain margins in case prices to customers decline.

— *Pollution.* Not only can a company be bankrupted by pollution-related lawsuits, but its officers can be found personally liable for them. Consequently, the CFO should be heavily involved in the investigation of all potential pollution issues at existing company facilities, while also making pollution testing a major part of all facility acquisition reviews. The CFO should also have a working knowledge of how all pollution-related legislation impacts the company.

— *Foreign exchange risk.* Investments or customer payables can decline in value due to a drop in the value of foreign currencies. The CFO should know the size of foreign trading or investing activity, be aware of the size of potential losses, and adopt hedging tactics if the risk is sufficiently high to warrant incurring hedging costs.

— *Adverse regulatory changes.* Changes in local, state, or federal laws—ranging from zoning to pollution controls and customs requirements—can hamstring corporate operations and even shut down a company. The CFO should be aware of pending legislation that could cause these changes, engage in lobbying efforts to keep them from occurring, and prepare the company for those changes most likely to occur.

— *Contract failures.* Contracts may have clauses that can be deleterious to a company, such as the obligation to order more parts than it needs, to make long-term payments at excessive rates, to be barred from competing in a certain industry, and so on. The CFO should verify the contents of all existing contracts, as well as examine all new ones, to ensure that the company is aware of these clauses and knows how to mitigate them.

— *System failures.* A company's infrastructure can be severely impacted by a variety of natural or man-made disasters, such as flooding, lightning, earthquakes, and wars. The CFO must be aware of these possibilities and have disaster recovery plans in place that are regularly practiced, so the organization has a means of recovery.

- *Succession failures.* Without an orderly progression of trained and experienced personnel in all key positions, a company can be impacted by the loss of key personnel. The CFO should have a succession planning system in place that identifies potential replacement personnel and grooms them for eventual promotion.
- *Employee practices.* Employees may engage in sexual harassment, stealing assets, or other similar activities. The CFO should coordinate employee training and set up control systems that are designed to reduce the risk of their engaging in unacceptable activities that could lead to lawsuits against the company or the direct incurrence of losses.
- *Investment losses.* Placing funds in excessively high-risk investment vehicles can result in major investment losses. The CFO should devise an investment policy that limits investment options to those vehicles that provide an appropriate mix of liquidity, moderate return, and a low risk of loss (see Chapter 13, Investing Excess Funds).
- *Interest rate increases.* If a company carries a large amount of debt whose interest rates vary with current market rates, then there is a risk that the company will be adversely impacted by sudden surges in interest rates. This risk can be reduced through a conversion to fixed interest-rate debt, as well as by refinancing to lower-rate debt whenever shifts in interest rates allow this to be done.

• *Link performance measures to strategy.* The CFO will likely inherit a companywide measurement system that is based on historical needs, rather than the requirements of its strategic direction. He or she should carefully prune out those measurements that are resulting in behavior not aligned with the strategic direction, add new ones that encourage working on strategic initiatives, and also link personal review systems to the new measurement system. This is a continuing effort, since strategy shifts will continually call for revisions to the measurement system.

• *Encourage efficiency improvements everywhere.* The CFO works with all department managers to find new ways to improve their operations. This can be done by benchmarking corporate operations against those of other companies, conducting financial analyses of internal operations, and using trade information about best practices. This task involves great communication skills to convince fellow managers to implement improvements, as well as the ability to shift funding into those areas needing it in order to enhance their efficiencies.

• *Clean up the accounting and finance functions.* While most of the items in this list involve changes throughout the organization, the CFO must create an ongoing system of improvements within the accounting and finance functions—otherwise the managers of other departments will be less likely to listen to a CFO who cannot practice what he preaches. To do this, the CFO must focus on the following key goals:

- *Staff improvements.* All improvement begins with the staff. The CFO can enhance the knowledge base of this group with tightly focused training, cross-training between positions, and encouraging a high level of communication within the group.