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FINANCE

Jean Pousson

Finance is an essential capability for any executive. Blind reliance on the chief finance officer (CFO)/finance director (FD) and/or other finance professionals will not serve as a defence in any court of law when there are problems. Having said that, most jurisdictions do not expect all directors to be as au fait on finance matters as their financially qualified colleagues, but there are expectations and requirements which have to be met.

The following are a list of questions for boards. The list is not exhaustive, but should nevertheless provide a good, easy, and useful framework. Some are reflective, but many are legitimate questions to ask during the course of a board meeting or outside of the board.

Governance and strategy

Is the board clear as to how the chosen strategy creates value for the shareholders? Is the board at one when the phrase “value creation” is used? What is the relationship with the shareholders? Is the dividend policy aligned with their expectations and the company’s strategy?

Although an understanding of the finance impact of strategic decisions is crucial, the board should never forget that corporate strategy drives the finance strategy. Not the other way around.

How influential is the CFO/FD? Is he or she collaborative with colleagues, or does he or she constantly dominate by throwing numbers to make his or her point?

Does the CFO/FD coach other board members on technical matters? Does he or she communicate in clear and easy to understand language? Who appraises the performance of the CFO/FD on technical issues?

How robust are the internal controls? Is the board comfortable about the relationship between the internal auditors and the finance function?

What is the relationship between the CFO/FD and the external auditors? “Combative” or “very friendly” are both worrisome answers. Do the finance people feel relaxed about welcoming external auditors, or is there a feeling of “We need to hide this”?

A clean external audit is not a clean bill of health. External auditors only give you an opinion. They cannot test and verify everything and, in that sense, can provide a certain degree of false comfort. Are external auditors’ letters seen by all the board members? Is the entire board comfortable with the materiality test threshold?

Is the audit committee well configured and does it work well within the board? Do the members challenge sufficiently? Is the chair of the audit committee sufficiently influential?

When looking at the risk register, have the risks and impact been monetised? That is, is it clear what the impact on revenues, profits, and cash would be if these items were to materialise?

How quickly are the management accounts produced? In an age of technology, these should not take very long. Are there endless adjustments that need to be made each month/quarter? If so why would that be?

Is the board dashboard fit for purpose? This presupposes that everyone understands the purpose of the organisation! Are the financial and technical items understood by all? Is there a healthy balance of financial and non-financial metrics? Is the reporting on ESG measures in line with good practice? And never forget, what is complicated is rarely useful and what is useful should not be complicated.

Does the CFO/FD communicate in plain and simple language? Does he or she treat simple questions with respect and humility?

Is there a simple corporate structure in place, or is there an intricate pyramid of subsidiaries? Why the apparent complexity? Are the related party transactions (that is, transactions between group companies and/or directors) sufficiently transparent and conducted at commercial arm's length?

Are all board members clear of the avenues to be pursued if they are uncomfortable? Could the audit committee, whistle-blower champion, internal and external auditors be available for counsel if required?

Accounting and financial health

Does the board fully understand all the accounting policies utilised by the company? Could this be easily explained to junior members of staff? Are proposed changes in accounting policies robustly challenged? If the business has not changed, why should the accounting policies change? Numerous accounting scandals have stemmed from this. The board should always treat with healthy suspicion a proposed change in accounting policy which has the immediate impact of improving profits.

The board has collective responsibility when signing off the annual report. Are all the facets fully understood? Does the report comply with the legal true and fair criterion? Are there material or significant post balance sheet items that merit a mention? Is there complete agreement (and understanding) about the adoption of the going concern statement?

Does the tax management regime seem appropriate? Or are the finance folk devoting too much time to reducing or deferring corporate and other taxes? Is the company's effective tax rate in line with peer competitors and previous periods? Where is the tax advice coming from?

Could any director speak comfortably about the financial health of the business? Are professional reviews from debt rating agencies and other similar bodies regularly discussed at board level?

A simple way to summarise a company's financial performance is by addressing the following variables: growth, profitability, efficiency, gearing, and liquidity.

Growth

Have revenues grown? What is driving the growth? Has the mix changed and is it likely to change further? Is that growth sustainable? Is the board

comfortable with the forecasts being presented? Are they in line with solid strategic and resource analysis? Are there any dependencies on one customer or industry? Is there a risk mitigant in place, that is, no one customer to make up more than x% of revenues?

Profitability

Is the business profitable? What is driving the levels of profitability? Is profitability per product, per division, or by which other metric appropriate for the business well defined?

Are all the profit margins fairly stable year on year and going forward? Are they acceptable for this type of business? What about the returns on equity and the returns on capital employed? Do they represent a good return on the capital provided? How does that compare with the company's own cost of capital (often called the weighted average cost of capital)?

Are the costs allocated as they should be? Is the board comfortable with the company's costing system? Have all expenses grown in line with increased activity?

Where is the business trading vis-à-vis its break-even point? By how much would revenues have to decline for a profit to turn into a loss? What is the level of operational gearing? A high level of operational gearing (that is, high percentage of fixed costs versus variable costs), makes the business vulnerable to sudden downturns or revenue contraction. However, profitability will be enhanced once the break-even point is exceeded. By contrast, a business with a low level of operational gearing (that is, low percentage of variable costs), is more flexible and can withstand a downturn better but would not achieve the same levels of profitability.

Are the interest charges (finance costs) well covered by the level of profits? Remember, cash matters for repayment and debt servicing. Are the finance costs in line with the borrowings? That is, a simple check is to compare the charge in the income statement against the loans as stated in the balance sheet.

Does the corporate tax charge look adequate? This is a charge and not necessarily the amount actually paid out to the tax authorities. The statement of cash flow is more instructive on that one.

Efficiency

Is the business using all its assets productively? Is the asset level in line with the nature of the business? Are the assets owned or leased? Check on the depreciation policy: Are the valuation criteria justified?

What is the policy on asset replacement? How are decisions made? What are the methods used?

The board should distinguish between discretionary and non-discretionary capital expenditure. Some assets have to be replaced; otherwise, product/service quality drops and the business suffers.

What does the working capital position look like? Is it an unnecessary drain on the cash flow, or is it well managed? Managing inventories, trade payables (debtors), and trade payables (creditors, suppliers) is important as a slight deterioration can cause a significant cash outflow if the business is sizeable.

Gearing

Sometimes referred to as financial leverage, gearing assesses the amount of debt that a business has raised. There are a number of different ways to calculate this, but in essence it is about comparing the debt levels against a number of parameters.

What is the business gearing percentage (that is, interest-bearing debt expressed as a percentage of equity)? Have all liabilities been considered (for example, a pension deficit, a guarantee given, a financial commitment and so on)? Does the board have a gearing policy? The measurements by themselves are just indicators. What is more important is to see the trends over a period of time. Why has the company borrowed? Typical reasons would be to finance a loss, to fund working capital requirements and capital expenditure. Borrowings could also be raised to pay dividends, make an acquisition, fund a capital restructuring, and so on. What about the utilisation? How much more could be drawn down at a moment's notice in line with current borrowing facilities?

What about financial flexibility? Could the business raise additional capital at relatively short notice if pushed? Cash flow is not a reason to borrow. A lack of cash flow is a result of other activities!

Once the rationale for the borrowings has been ascertained, the obvious question is: Can the business afford to service the costs and repayments? Only a full cash flow analysis will reveal this. Have all debt repayments been stress-tested? That is, what if there was an interest rate shock? What if there was a business shock, that is, a drop and/or delayed revenues, loss of a big client, unexpected cost, and so on? Could the debt repayments still be made?

Is the management of banks and other financiers well in hand?

Liquidity

Cash is king. You will only run out of cash once! Sales are vanity, profits are sanity, and cash is reality. These statements have held sway for decades and will continue to do so.

Does the board understand the difference between profits and cash? Does the board understand the cash flow drivers and the cash conversion cycle, that is, how profits eventually turn into cash?

EBITDA ((earnings before interest and tax, add back depreciation and amortisation) is widely used in business and has developed a following. It is a measurement which is a rough proxy for cash flow. It is not free cash flow. Free cash flow is the cash left over (if any) after all cash outlays have been taken into account. Could any board member walk through the statement of cash flow with bankers and other financiers if they were asked to comment on the business liquidity? If ever in doubt, the banking records do not lie. Do they reconcile with internal cash flows provided? Is the business cash positive or cash negative? If cash flow is negative, why? How was the deficit funded? When will this position become positive? A business cannot be cash negative forever.

My final few thoughts are perhaps aimed at individual directors. Do not be fooled by the apparent simplicity of these comments. They are very powerful:

Trust your instincts? No! Obey them! If something doesn't feel right it probably is not right. A good director is tenacious and will never rest until he or she gets a satisfactory answer.

Large profits that you don't understand are far more dangerous than losses that you do. If it looks too good to be true, it probably is. So, question and question again. As a director, you are well within your rights to ask and ask again. And don't ever be satisfied with answers such as "It is for tax reasons," "It is strategic," "We can't afford this," or "It is for legal reasons." A good CFO/FD would never hide behind such vague responses.