

# CFO

## FUNDAMENTALS

### YOUR QUICK GUIDE TO

- ✓ Internal Controls
- ✓ Financial Reporting
- ✓ IFRS
- ✓ Web 2.0
- ✓ Cloud Computing
- ✓ and More

Jae K. Shim • Joel G. Siegel • Allison I. Shim



# CFO Fundamentals

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# CFO Fundamentals

*Your Quick Guide to  
Internal Controls, Financial  
Reporting, IFRS, Web 2.0,  
Cloud Computing, and More*

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*To Chung Shim, dedicated wife and mother;  
Roberta M. Siegel, loving wife and colleague;  
and Sylvia and Arnold Siegel, loving mother and brother.*





# Contents

## What This Book Will Do for You    xv

### PART ONE: REPORTS AND FILINGS

|  |           |
|--|-----------|
| <b>1: Chief Financial Officer's Role and Reports</b> | <b>3</b>  |
| Role of the Chief Financial Officer                  | 3         |
| Governmental Reporting                               | 12        |
| Reporting under the Sarbanes-Oxley Act               | 12        |
| XBRL Reporting                                       | 13        |
| Other Reporting                                      | 14        |
| <b>2: Securities and Exchange Commission Filings</b> | <b>15</b> |
| SEC Rules  | 15        |
| S Forms  | 16        |
| SEC Regulations                                      | 17        |
| SOX Reporting Requirements                           | 19        |

### PART TWO: FINANCIAL REPORTING

|   |           |
|---|-----------|
| <b>3: Financial Statement Reporting: The Income Statement</b> | <b>27</b> |
| How Is the Income Statement Presented?                        | 27        |
| Revenue Recognition   | 30        |
| Construction Contracts  | 31        |
| Expense Recognition   | 37        |
| <b>4: Financial Statement Reporting: The Balance Sheet</b>    | <b>45</b> |
| Assets  | 45        |
| Accounts Receivable   | 46        |
| Inventory   | 49        |
| Fixed Assets  | 54        |
| Disclosure  | 62        |
| Liabilities   | 65        |
| Accounting for Compensated Absences                           | 72        |
| Environmental Obligations                                     | 74        |
| Exit or Disposal Activities                                   | 75        |

|  |            |
|--|------------|
| Fair Value Measurements  | 76         |
| Fair Value Option for Financial Assets and Financial Liabilities                                   | 78         |
| Statement of Cash Flows  | 80         |
| Available-for-Sale and Held-to-Maturity Securities   | 82         |
| <b>5: Statement of Cash Flows</b>  | <b>95</b>  |
| Classifications of Cash Flow   | 95         |
| Analysis of the Statement of Cash Flows  | 100        |
| <b>6: Accounting and Disclosures</b>   | <b>107</b> |
| Accounting Changes   | 107        |
| Futures Contracts  | 119        |
| Various Disclosures  | 122        |
| <b>7: Key Financial Accounting Areas</b>   | <b>125</b> |
| Consolidation  | 125        |
| Investments in Stocks and Bonds  | 127        |
| Leases   | 138        |
| Pension Plans  | 147        |
| Postretirement Benefits Excluding Pensions   | 158        |
| Income Tax Allocation  | 161        |
| Deferred Tax Liability versus Deferred Tax Asset   | 164        |
| Tax Rates  | 167        |
| Foreign Currency Accounting  | 169        |
| Translation of Foreign Currency Statements When the Foreign<br>Currency Is the Functional Currency | 172        |
| International Financial Reporting Standards  | 177        |
| <b>8: Interim and Segmental Reporting</b>  | <b>185</b> |
| Interim Reporting  | 185        |
| Segmental Reporting  | 188        |



## **PART THREE: COST MANAGEMENT AND IT SYSTEMS**

|   |            |
|---|------------|
| <b>9: Cost Management and Analysis</b>              | <b>197</b> |
| What Is Cost Management and Analysis?               | 197        |
| Strategic Cost Management                           | 198        |
| Overhead Costing                                    | 199        |
| Activity-Based Costing                              | 205        |
| Activity-Based Management                           | 210        |
| Target Costing and Pricing                          | 214        |
| <b>10: Cost-Volume-Profit Analysis and Leverage</b> | <b>219</b> |
| Cost-Volume-Profit Analysis                         | 219        |
| What-If Analysis                                    | 223        |

|  |            |
|--|------------|
| Sales-Mix Analysis   | 225        |
| CVP Analysis for Nonprofit Organizations                             | 227        |
| Leverage   | 228        |
| <b>11: Short-Term Decisions</b>                                      | <b>233</b> |
| Relevant Costs   | 233        |
| Best Use of Scarce Resources   | 241        |
| Theory of Constraints  | 242        |
| <b>12: Financial Forecasting, Planning, and Budgeting</b>            | <b>245</b> |
| Financial Forecasting: The Percent-of-Sales Method                   | 245        |
| Budgeting  | 247        |
| Some Financial Calculations  | 257        |
| Budgeting Software   | 257        |
| Using an Electronic Spreadsheet to Develop a Budget Plan             | 257        |
| Latest Generation of Budgeting and Planning Software and E-Budgeting | 259        |
| <b>13: Risk Management</b>   | <b>261</b> |
| Enterprise Risk Management   | 261        |
| An Approach to Risk Management                                       | 263        |
| A Close Look at Risk Management                                      | 264        |
| How to Reduce Investment Risk: Diversify                             | 267        |
| Beta—The Capital Asset Pricing Model                                 | 271        |
| Arbitrage Pricing Model  | 272        |
| <b>14: Capital Budgeting and Real Options</b>                        | <b>275</b> |
| Time Value Fundamentals  | 276        |
| Popular Evaluation Techniques  | 280        |
| Limited Funds for Capital Spending                                   | 286        |
| Real Options   | 289        |
| Discovery-Driven Planning  | 290        |
| Effect of Income Taxes on Capital Budgeting Decisions                | 290        |
| <b>15: The What and Why of Responsibility Accounting</b>             | <b>297</b> |
| Responsibility Accounting Basics                                     | 297        |
| Cost Center Performance and Standard Costs                           | 298        |
| Flexible Budgets and Performance Reports                             | 304        |
| Production Mix and Yield Variances                                   | 308        |
| <b>16: Control of Profit Centers</b>                                 | <b>313</b> |
| How Do You Evaluate Profit Centers?                                  | 313        |
| Profit Variance Analysis   | 315        |
| <b>17: Performance of Investment Centers and Transfer Pricing</b>    | <b>323</b> |
| Rate of Return on Investment   | 323        |
| Residual Income  | 324        |

|                                       |     |
|---------------------------------------|-----|
| Investment Decisions under ROI and RI | 324 |
| Transfer Pricing                      | 325 |

## **18: How to Analyze and Improve Corporate Profitability and Shareholder Value 331**

|   |     |
|---|-----|
| Measures of Managerial Performance and Shareholder Return | 331 |
| Sustainable Rate of Growth                                | 339 |
| Economic Value Added                                      | 340 |
| Balanced Scorecard  | 345 |

## **19: Information Technology and IT Systems 349**

|  |     |
|--|-----|
| Computer Technologies Available for Business           | 349 |
| Role of Information Systems in the Strategic Plan      | 350 |
| Management Information Systems                         | 351 |
| Who Uses Executive Information Systems?                | 351 |
| Value Chain Management Software                        | 353 |
| Extensible Business Reporting Language                 | 356 |
| Web 2.0  | 357 |
| Cloud Computing and Competitive Advantage              | 358 |
| Mobile Computing (Wireless Technology)                 | 360 |
| Handheld Device Security and Contingency Planning      | 362 |
| Disaster Recovery and Business Continuity Planning     | 363 |
| CFO's View of Information Technology: A Current Survey | 364 |



## **PART FOUR: MANAGEMENT OF ASSETS AND LIABILITIES**

### **20: Working Capital and Cash Management 369**

|                               |     |
|-------------------------------|-----|
| Evaluating Working Capital    | 369 |
| Cash Management               | 370 |
| Cash Management Models        | 378 |
| Banking Relationships         | 381 |
| International Cash Management | 382 |

### **21: Management of Accounts Receivable 385**

|                                   |     |
|-----------------------------------|-----|
| Managing Receivables              | 385 |
| Investment in Accounts Receivable | 388 |

### **22: Inventory Management 395**

|   |     |
|---|-----|
| Inventory Recording and Control           | 395 |
| Inventory Costs                           | 401 |
| Economic Order Quantity                   | 402 |
| Reorder Point                             | 403 |
| How to Find the Optimal Safety Stock Size | 406 |

|  |            |
|--|------------|
| ABC Inventory Control  | 409        |
| Service Business   | 409        |
| <b>23: Management of Payables</b>  | <b>411</b> |
| Accounts Payable System  | 411        |
| Managing Payables  | 413        |
|  <b>PART FIVE: FINANCING THE BUSINESS</b> |            |
| <b>24: Short-Term and Intermediate-Term Financing</b>  | <b>417</b> |
| Short-Term Financing   | 417        |
| Intermediate-Term Financing  | 433        |
| <b>25: Long-Term Financing</b>   | <b>439</b> |
| Types of Long-Term Debt and When Each Should Be Used   | 440        |
| Issuance of Equity Securities  | 448        |
| Financing Strategy   | 456        |
| <b>26: Warrants and Convertibles</b>   | <b>465</b> |
| Warrants   | 465        |
| Convertible Securities   | 467        |
| <b>27: Cost of Capital and Capital Structure Decisions</b>   | <b>475</b> |
| Individual Costs of Capital  | 475        |
| Weights  | 479        |
| EBIT–EPS Approach to Capital Structure Decisions   | 482        |
| Analysis of Corporate Cash Flows   | 485        |
| Coverage Ratios  | 485        |
| Capital Structure Decisions  | 487        |
| <b>28: Dividend Policy</b>   | <b>489</b> |
| Types of Dividend Policies   | 489        |
| Variables to Be Considered   | 491        |
| <b>29: Financial Management of Multinational Corporations</b>  | <b>495</b> |
| Financial Management Essentials for MNCs   | 495        |
| Foreign Exchange Market  | 496        |
| Financial Strategies   | 499        |
| Types of Foreign Exchange Exposure   | 499        |
| Interest Rate Parity   | 505        |
| Purchasing Power Parity  | 506        |
| Appraising Foreign Investments   | 507        |
| Financing  | 509        |
| Analysis of Foreign Investments  | 512        |



## **PART SIX: FINANCIAL ANALYSIS, INSURANCE AND LEGAL CONSIDERATIONS, AND ECONOMICS**

|   |            |
|---|------------|
| <b>30: Financial Statement Analysis</b>   | <b>521</b> |
| Financial Analysis Essentials   | 521        |
| Balance Sheet Analysis  | 523        |
| Potential for Business Failure  | 540        |
| Income Statement Analysis   | 543        |
| Market Value Ratios   | 549        |
| Analyzing the Financial Structure of the Firm                                   | 550        |
| Product Line Measures   | 553        |
| Industry Characteristics Indicative of Greater Risk                             | 555        |
| Considerations in Foreign Operations  | 556        |
| <b>31: Analysis, Evaluation, and Control of Revenue and Costs</b>               | <b>557</b> |
| Control Reports   | 557        |
| Control of Costs  | 560        |
| Performance Measures  | 562        |
| Business Processes  | 564        |
| <b>32: Insurance and Legal Considerations</b>                                   | <b>567</b> |
| Insurance Protection  | 567        |
| Types of Insurance  | 569        |
| Medical and Catastrophe Coverage  | 573        |
| Liability Insurance Coverage for CFOs   | 575        |
| Business Law  | 575        |
| <b>33: Reading Economic Indicators</b>  | <b>577</b> |
| How Can You Keep Track of the Economy with<br>Economic and Monetary Indicators? | 577        |
| Housing-Related Measures  | 582        |
| Indices of Leading, Coincident, and Lagging Economic Indicators                 | 583        |
| Other Important Economic Indices  | 585        |
| Monetary Indicators and How They Impact the Economy                             | 586        |
| Understanding Economic Data and Indicators                                      | 592        |
| Economic Indicators and Stocks and Businesses                                   | 593        |
| Economic Indicators and Bond Yields   | 593        |



## **PART SEVEN: LIQUIDITY AND TREASURY**

|  |            |
|--|------------|
| <b>34: Corporate Investments in Securities</b> | <b>597</b> |
| Cash and Liquidity Management                  | 597        |
| Terms and Features of Bonds                    | 600        |
| Other Fixed Income Investments                 | 609        |

|   |     |
|---|-----|
| Money Market Preferred Stock                    | 614 |
| Private Equity                                  | 615 |
| Current Trends in Liquidity Management Strategy | 616 |

## PART EIGHT: TAXATION

|   |            |
|---|------------|
| <b>35: Tax Factors in Financial Decision Making</b> | <b>621</b> |
| What Should You Know about Taxes?                   | 621        |
| Gross Income  | 622        |
| Depreciation  | 624        |
| Amortization  | 624        |
| Tax Planning  | 626        |

## PART NINE: MERGERS AND ACQUISITIONS, DIVESTITURES, FAILURE, AND REORGANIZATION

|   |            |
|---|------------|
| <b>36: Mergers and Acquisitions</b>                 | <b>631</b> |
| Valuation   | 631        |
| Fair Market Value of Net Assets                     | 639        |
| Capitalization of Revenue                           | 640        |
| Price/Earnings Ratio                                | 641        |
| Similar Businesses                                  | 642        |
| Sales of Stock                                      | 643        |
| Combination of Methods                              | 643        |
| Successful Strategy for Mergers and Acquisitions    | 644        |
| <b>37: Divestiture</b>                              | <b>645</b> |
| Why Divest?   | 645        |
| Asset Valuation Methods                             | 647        |
| Profitability Methods                               | 648        |
| Market-Based Comparisons                            | 648        |
| Discounted Cash Flow Analysis                       | 649        |
| Divestiture with Uncertainty                        | 651        |
| <b>38: Forecasting Corporate Financial Distress</b> | <b>655</b> |
| Prediction Models                                   | 656        |
| Z-Score Model                                       | 656        |
| Applications  | 657        |

|  |            |
|--|------------|
| <b>39: Failure and Reorganization</b>  | <b>667</b> |
| Business Failure   | 667        |
| Reorganization   | 669        |
| <b>40: Valuation of Bonds and Stocks</b>   | <b>679</b> |
| How to Value a Security  | 679        |
| How to Value Bonds   | 680        |
| How to Value Preferred Stock   | 683        |
| How to Value Common Stock  | 684        |
| Price/Earnings Ratio Approaches  | 688        |
| Other Pragmatic Approaches   | 693        |
| The Bottom Line  | 694        |
| <b>41: Financial Statement Analysis: Key Financial Ratios and Metrics for Nonprofits</b> | <b>697</b> |
| Trend Analysis   | 698        |
| Analysis of the Balance Sheet  | 699        |
| Liquidity Analysis   | 699        |
| Appraisal of Solvency, Capital Structure, and Net Assets (Fund Balance)                  | 704        |
| Evaluation of the Statement of Activities  | 704        |
| Performance Metrics  | 707        |
| Spotting Potential Bankruptcy and Avoiding Financial Problems                            | 711        |
| Case Study in Financial Statement Analysis   | 714        |
| <b>Appendix</b>  | <b>725</b> |
| <b>About the Authors</b>   | <b>729</b> |
| <b>Index</b>   | <b>731</b> |



# What This Book Will Do for You

**H**ERE IS A handy pocket problem-solver for today's busy chief financial officer (CFO). It's a working guide to help you quickly pinpoint what to look for, what to be aware of, what to do, and how to do it in the complex world of business. You will find checklists, ratios, formulas, measures, guidelines, procedures, rules of thumb, illustrations, step-by-step instructions, real-life examples, tables, charts, and exhibits to help you analyze and evaluate any business-related problem. Throughout, you will find this book practical, quick, comprehensive, and useful.

Uses for this book are as varied as the topics presented. It can be used by CFOs employed by large, medium, or small companies.

You will be able to move quickly to take advantage of favorable situations and avoid unfavorable ones. Here is the guide that will help you make smart decisions. The book provides analysis of recurring problems as well as unusual ones that may occur and posts red flags of potential difficulties. It gives vital suggestions throughout on correcting financial sickness and inefficiency. The latest developments, such as new tax laws, are included.

The book covers the major areas and problems of corporate financial management and accounting. It is directed to the modern CFO who must follow some traditional elements common to controllership and financial management but must be cognizant of the ever-changing financial markets and technology of today. These factors make some of the traditional techniques of financial management obsolete; new strategies and techniques are necessary in order to do an effective job that ensures financial survival.

We present guidelines for evaluating proposals and for analyzing and measuring operations and activities and provide tips for preparing necessary reports.

The book is a practical reference that contains approaches and techniques for understanding and solving problems of:

- Financial reporting: International Financial Reporting Standards (IFRS)
- Cost management and information technology (IT) systems
- Financial planning and budgeting
- Management of assets and liabilities
- Risk management and continuity planning
- Liquidity and treasury
- Financing the business
- Real options and discovery-driven planning
- Taxation

- Mergers and acquisitions
- Divestitures
- Multinational finance
- Forecasting corporate bankruptcy
- Reading economic indicators

Part I (Chapters 1–2) covers the financial reporting responsibilities of the CFO, including the types of reports that must be prepared. Securities and Exchange Commission filings are required by public companies, and compliance with the Sarbanes-Oxley Act is required.

Part II (Chapters 3–8) discusses the financial accounting requirements applicable to the income statement, balance sheet, and statement of cash flows. Generally accepted accounting principles are delved into, including such important topics as leases, pensions, and accounting for income taxes.

Part III (Chapters 9–19) focuses on cost management and IT systems. It covers what the CFO should know about cost management and analysis, break-even analysis, contribution margin analysis, budgeting and financial modeling, variance analysis, risk management, portfolio diversification sustainable growth, capital budgeting, managerial reports, segmental performance, and quantitative techniques. Chapter 19 takes up the issue as to how IT assists CFOs in business decisions. It covers the use of information systems in all phases of business and in all functional areas to analyze and solve business problems in the real world. It covers topics such as cloud computing, Web 2.0, value chain software, and contingency planning.

Part IV (Chapters 20–23) addresses the management of working capital and assets including cash, accounts receivable, and inventory. The management of payables is also highlighted.

Part V (Chapters 24–29) deals with how to adequately obtain financing for the business to meet its goals and financial needs. Short-term, intermediate-term, and long-term financing requirements are discussed, and the circumstances under which each would be appropriate are indicated. Cost of capital determination and capital structure decisions are presented. The factors in establishing a dividend policy are noted. The financial management of overseas operations for multinational companies is explained.

Part VI (Chapters 30–33) is directed toward financial analysis areas, including risk/reward relationships and financial statement analysis for internal evaluation. Ways to analyze and control revenue and expenses are addressed. Proper insurance is needed to ensure the sustenance of the business. Knowledge of law is required to guard against legal exposure such as from product defects. The economic environment by way of economic indicators and statistics has to be studied to determine its impact on the business and what can be done in recessionary times.

Part VII (Chapter 34) covers investment portfolio selection so as to earn a satisfactory return while controlling risk. Current trend in corporate investment and liquidity management is also outlined.

Part VIII (Chapter 35) discusses the tax consequences of making financial decisions. Tax planning is essential to minimizing the tax obligation of the business.

Part IX (Chapters 36–41) presents the planning and financial aspects for mergers and acquisitions. The reasons and ways of divesting of business segments are discussed. The signs of potential business failure must be noted so that timely corrective action may be taken. The steps in a reorganization are discussed. Chapter 40 provides an in-depth treatment as to how to value a security. Chapter 41 addresses a special topic—financial analysis for nonprofit organizations.

The content of the book is clear, concise, and to the point. It is a valuable reference tool with practical applications and how-tos for you, the up-to-date knowledgeable CFO. Keep this book handy for easy reference and daily use.





# PART ONE

## **Reports and Filings**



# Chief Financial Officer's Role and Reports

## ROLE OF THE CHIEF FINANCIAL OFFICER

The chief financial officer (CFO) plays a strategic role in the company's goal-setting, policy determination, and financial success. The CFO's typical title is vice president of finance (VP Finance). Unless the business is small, no one individual handles all the financial decisions; responsibility is dispersed throughout the organization. The CFO's responsibilities include:

- *Financial analysis and planning:* Determining the amount of funds the company needs; a large company seeking a rapid growth rate will require more funds.
- *Making investment decisions:* Allocating funds to specific assets (things owned by the company). The financial manager makes decisions regarding the mix and type of assets acquired and the possible modification or replacement of assets, particularly when assets are inefficient or obsolete.
- *Making financing and capital structure decisions:* Raising funds on favorable terms (i.e., at a lower interest rate or with few restrictions). Deciding how to raise funds depends on many factors, including interest rate, cash position, and existing debt level; for example, a company with a cash-flow problem may be better off using long-term financing.
- *Managing financial resources:* Managing cash, receivables, and inventory to accomplish higher returns without undue risk.

The CFO affects stockholder wealth maximization by influencing:

- Current and future earnings per share (EPS), equal to net income divided by common shares outstanding

- Timing, duration, and risk of earnings
- Dividend policy
- Manner of financing

Exhibit 1.1 presents the functions of the CFO.

**EXHIBIT 1.1** Functions of the CFO

**A. Accounting and Control**

Establishment of accounting policies and internal control  
 Development and reporting of accounting data  
 Cost accounting  
 Internal auditing  
 System and procedures  
 Government reporting and filings  
 Report and interpretation of results of operations to management  
 Comparison of performance with operating plans and standards

**B. Planning**

Long- and short-range financial and corporate planning  
 Budgeting for operations and capital expenditures  
 Evaluating performance  
 Pricing policies and sales forecasting  
 Analyzing economic factors  
 Appraising acquisitions and divestment

**C. Provision of capital**

Short-term sources; cost and arrangements  
 Long-term sources; cost and arrangements  
 Internal generation

**D. Administration of Funds**

Cash management  
 Banking arrangements  
 Receipt, custody, and disbursement of company's securities and moneys  
 Credit and collection management  
 Pension money management  
 Investment portfolio management

**E. Protection of Assets**

Provision for insurance  
 Establishment of sound internal controls

**F. Tax Administration**

Establishment of tax policies  
 Preparation of tax reports  
 Tax planning

(continued)



**EXHIBIT 1.1** (continued)**G. Investor Relations**

Maintaining liaison with the investment community  
 Counseling with analyst regarding public financial information

**H. Evaluation and Consulting**

Consultation with and advice to other corporate executives on company policies, operations, objectives, and their degree of effectiveness

**I. Information Technology and Management Information Systems**

Development and use of information technology (IT) facilities  
 Development and use of management information systems  
 Development and use of IT systems and procedures

## How do you differentiate among the controller, treasurer, and CFO?

If you are employed by a large company, the financial responsibilities are probably held by the controller, treasurer, and CFO. The activities of the controller and treasurer fall under the umbrella of finance.

There is no precise distinction between the jobs of controller and treasurer, and the functions may differ slightly between organizations because of size, company policy, and the personality of the office holder. In most businesses, the role of the controller is constantly changing and adapting to the situation at hand. The controller's functions are primarily of an *internal* nature and include record keeping, tracking, and controlling the financial effects of prior and current operations. The *internal* matters of importance to the controller include financial reporting, internal control and compliance, cost and managerial accounting, taxes, control, and audit functions. The controller is the chief accountant and is involved in the preparation of financial statements, tax returns, the annual report, and filings with the Securities and Exchange Commission (SEC). The controller's function is primarily to ensure that funds are used efficiently. He or she is primarily concerned with collecting and presenting financial information. The controller usually looks at what has occurred rather than what should or will happen.

Many controllers are involved with management information and IT systems, and review previous, current, and emerging IT patterns. They report their analysis of the financial implications of decisions to top management. Controllers are called on to establish, monitor, and analyze the internal control structure of the company to the extent that those controls impact the company's financial statements. At times, controllers may be called on to consider operational controls broader in scope. In particular, for SEC registrants that fall under Sarbanes-Oxley 404 requirements, controllers are required to obtain an independent auditor's opinion as to whether the control design and operating effectiveness are able to prevent a material misstatement in the financial statements. For entities that are not SEC registrants, much of the Sarbanes-Oxley 404 requirement could be considered best practice. In this regard, a risk-based control self-assessment program is a useful starting point. Tools such as internal control questionnaires or

process maps may be useful. It is important to keep in mind that every company is different, and, therefore, the internal control self-assessment process should be tailored to the particular needs and peculiarities of each company. When designing a control self-assessment process or modifying controls, it would be prudent to obtain the external auditor's view at the onset to facilitate that auditor's function and lessen audit costs.

The treasurer's function, in contrast, is primary external. The treasurer obtains and manages the corporation's capital and is involved with creditors (e.g., bank loan officers), stockholders, investors, underwriters of equity (stock) and bond issuances, and governmental regulatory bodies (e.g., the SEC, Public Company Accounting Oversight Board [PCAOB]). The treasurer is responsible for managing corporate assets (e.g., accounts receivable, inventory) and debt, planning the finances and capital expenditures, obtaining funds, formulating credit policy, and managing the investment portfolio.

The treasurer concentrates on keeping the company afloat by obtaining cash to meet obligations and buying assets to achieve corporate objectives. While the controller concentrates on profitability, the treasurer emphasizes cash flow. Even though a company has been profitable, it may have a significant negative cash flow; for example, there may exist substantial long-term receivables (receivables having a maturity of greater than one year). Without adequate cash flow, even a profitable company may fail. By emphasizing cash flow, the treasurer strives to prevent bankruptcy and achieve corporate goals. The treasurer analyzes the financial statements, formulates additional data, and makes decisions based on the analysis.

The major responsibilities of controllers and treasurers are summarized in Exhibit 1.2. Typically, both report to the *chief financial officer*. The CFO is involved with financial policy making and planning. He or she has financial and managerial responsibilities, supervises all phases of financial activity, and serves as the financial advisor to the board of directors. In the post-Enron era, the CFO's role has taken on a whole new level

#### EXHIBIT 1.2 Functions of Controller and Treasurer

| Controller  | Treasurer   |
|---|---|
| Internal controls   | Obtaining financing                                 |
| Financial reporting—SOX, SEC, generally accepted accounting principles, International Financial Reporting Standards | Banking relationship                                |
| Risk management   | Credit appraisal                                    |
| Custody of records  | Investment of funds                                 |
| Interpretation of financial data  | Investor relations                                  |
| Budgeting and planning  | Cash management                                     |
| Controlling operations  | Insuring assets                                     |
| Appraisal of results and making recommendations   | Fostering relationship with creditors and investors |
| Preparation of taxes  | Collecting funds                                    |
| Managing assets and IT systems  | Managing assets                                     |

of importance—nearly as important as the job of the chief executive officer (CEO). The new reporting rules instituted by the mandate of the Sarbanes-Oxley Act of 2002 (SOX; the Act) require that CFOs and CEOs sign off on their companies' financials not once but twice. The certification puts CFOs at risk of criminal penalties for materially misrepresenting the numbers. That alone makes the CFO position more daunting.

Exhibit 1.3 shows an organization chart of the finances structure within a company. Note that the controller and treasurer report to the VP Finance. For smaller companies, the controller is usually the CFO.

The CFO must communicate important and accurate financial information to senior-level executives, the board of directors and its audit committee, divisional managers, employees, and various third parties. The reports must be prepared in a timely fashion and be comprehensible and relevant to readers.

The needs of management differ among organizations. Management reports should be sufficiently simple to enable readers to concentrate on problems and difficulties that may arise. The reports should not be cumbersome to read through; they should be consistent and uniform in format. The facts presented should be based on supportable financial and accounting data. The CFO should use less accounting jargon and more operating terminology when reporting to management. Also, the reports should generate questions for top management discussions.

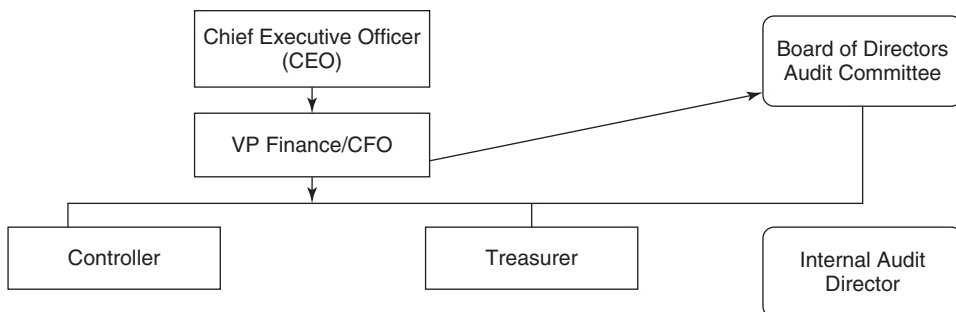
### What are prospective financial statements?

Prospective financial statements include financial forecasts and projections. This category excludes pro forma financial statements and partial presentations.

Financial forecasts are prospective financial statements that present the company's expected financial position as well as results of operations and cash flows, based on assumptions about conditions actually anticipated to occur and on the management action expected to be taken.

A financial forecast may be presented in a single dollar amount based on the best estimate or as a reasonable range. However, this range cannot be selected in a misleading way.

In contrast, financial projections are prospective statements that present the company's financial position, results of operations and cash flows, based on assumptions



**EXHIBIT 1.3** A Typical Financial Structure

about conditions anticipated to exist and the action management is expected to take, given the hypothetical (what-if) assumptions.

Financial projections may be most useful to users who seek answers to hypothetical questions. These users may want to change the scenarios based on expected changing situations. A financial projection may contain a range.

A financial projection may be prepared for general users *only* if it supplements a financial forecast. However, financial projections may not be contained in general-use documents and tax-shelter prospectuses.

### **What should be contained in financial forecasts and financial projections?**

Financial forecasts and financial projections may be in the form of complete basic financial statements or financial statements containing the following minimum items:

- Sales or gross revenues
- Net income
- Gross profit
- Basic and basic diluted EPS
- Income from continuing operations
- Income from discontinued operations
- Unusual income statement items
- Tax provision
- Material changes in financial positions
- Summaries of significant accounting policies and assumptions

Management's intent of preparing the prospective financial statements should be stated. However, there should be a mention that prospective results may not materialize. Also, it should be clearly stated that the assumptions used by management are based on information and circumstances that existed at the time the financial statements were prepared.

### **What are the various kinds of planning reports that can be prepared?**

The CFO can prepare short-term companywide or division-wide planning reports. These include the forecasted balance sheet, forecasted income statement, forecasted statement of cash flows, and projections of capital expenditures.

Special short-term planning studies of specific business segments may also be prepared. These reports may relate to product distribution by territory and market, product line mix analysis, warehouse handling, salesperson performance, and logistics. Long-range planning reports may include 5- to 10-year projections for the company and its major business segments.

Specialized planning and control reports may include the effects of cost-reduction programs, production issues in cost/quality terms, cash flow plans for line-of-credit agreements, evaluation of pension/termination costs in plant closings, contingency and downsizing plans, and appraisal of risk factors in long-term contracts.

## **Why are information reports useful?**

The CFO may prepare information reports for other members of top management. The reports can show and discuss long-term financial and operating trends. For example, the reasons and analytical implications of trends in revenue, production, and costs can be presented over the last three years. Although the format of such reports may vary depending on the environmental considerations and user needs, graphic depiction is often enlightening.

## **How can reports be used to analyze and control operations?**

Reports can be prepared dealing with controlling financial activities and related analytical implications. Analytical procedures include comparing financial and nonfinancial information over time. The reports can highlight the reasons for significant change between prior- and current-year performance. For example, a sharp increase in promotion and entertainment expense or telephone expense may require investigation. Analytical reports are also used to summarize and evaluate variances from forecasts and budgets. Appraisal of variances may be by revenue, expense, profit, assets, product, division, and territory.

## **Why are exceptions to the norm significant to note?**

Exception reports present detailed enumeration of the problems and difficulties faced by the business over a given time period. Such reports might zero in on internal control structure inadequacies or improper employment of accounting or auditing procedures in violation of generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). The computer should automatically output exception reports when a red flag is posted, such as when a customer's balance exceeds the credit limit.

## **What should the board of directors know?**

The board of directors usually is concerned with overall policy matters, general trends in revenue and earnings, and what the competition is doing. It is also interested in short-term and long-term issues. Relevant information in reports directed to the board of directors include company and divisional performance reports, historical and forecasted financial statements, status reports applicable to capital expenditures, and special studies. SOX requires an independent audit committee within the board. The board's audit committee is responsible for the selection and oversight of the auditing certified public accounting (CPA) firm.

## **What special occurrences should be reported?**

Special situations and circumstances may occur that require separate evaluation and study. For example, it may be necessary to identify the cause for a repeated decline in profitability of a given product, service, or territory. There may be a need for a feasibility analysis of whether to open a new store location or plant. Other reports may be

in connection with union negotiations, commercial contract reviews, pension plan administration, bonus plans, and product warranty issues. It is essential that the reports contain narrative and statistical analyses of the decision with graphic presentations as needed.

### **What reports may segment managers find useful in decision making?**

Reports prepared to assist divisional managers in evaluating performance and improving operating results include:

- Dollar sales and volume
- Profitability by product line, service, project, program, and territory
- Return on investment and residual income
- Divisional contribution margin, segment margin, and short-term performance margin
- Actual and budgeted costs by cost center
- Cash flow
- Labor and plant utilization
- Backlog
- Comparisons of each division's performance to other divisions within the company and to competing divisions in other companies

The CFO should determine whether current reporting may be improved. In one case, one of the authors, Professor Siegel, consulted with a company in which a maintenance and repair department manager prepared reports focusing solely on machine downtime. The reports concentrated on expenditures for repairs due to equipment breakdowns. Instead, the author recommended that the focus of attention should be on improving the productivity of manufacturing facilities. Hence, it is more constructive to look at uptime (machine usage) rather than downtime and to allocate resources accordingly. A machine uptime index may be computed. One can also analyze the production cycle period. This is the time between the receipt of an order and delivery to the customer, and it should be monitored on a regular basis.

### **How can reports be directed to improving quality?**

Reports can be prepared with the view of improving the quality of goods and/or services while controlling costs. What is the cost effectiveness of contemplated quality improvements? Of course, there is a trade-off between better quality and increased costs. Attention should be directed to curing defects that cause project delays. Cost considerations include overtime, rework, scrap, and capital outlays. The reports should concentrate on the accumulated costs of actions that promote quality. The costs include material inspection, quality control, preventive maintenance, and sampling. The CFO should also consider the increased costs associated with poor-quality products and/or services, such as warranties, promotional expenditures to improve the company's image, and legal liability settlements.