

CFO TECHNIQUES

A HANDS-ON GUIDE TO
KEEPING YOUR BUSINESS
SOLVENT AND SUCCESSFUL

How to be a
great CFO or
controller

BY
MARINA GUZIK

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Contents

About the Author	vii
About the Technical Reviewer	viii
Acknowledgments	ix
Introduction	xi
Part I: Scouting Your Surroundings and Defining Your Mission.....	I
Chapter 1: What Is Special About Smaller Businesses?	3
Chapter 2: Titles vs. Job Descriptions	9
Chapter 3: The CFO's Mission and Aspirations	15
Chapter 4: Eight Balls You Must Keep in the Air	21
Chapter 5: The Essential Knowledge Prerequisites	27
Part II: Enforcing the Law: Policies, Procedures, and Controls	33
Chapter 6: System of Internal Control and Company Policies	35
Chapter 7: Generally Accepted Fiscal Policies.....	43
Chapter 8: Procedures for Quintessential Tasks	53
Chapter 9: The Weakest Link.....	65
Chapter 10: Budgeting as a Control Mechanism	77
Chapter 11: Controlling Commerce	85
Part III: Deep Pockets: Your Capital Resources	93
Chapter 12: Options for Capital Financing	95
Chapter 13: Business Nature vs. Financial Resources	113
Chapter 14: Soliciting Investors and Lenders	123
Chapter 15: Nurturing Financial Relationships.....	131
Part IV: Cash Must Flow: Treasury Management	139
Chapter 16: The Gist of the Treasury Function	141

Chapter 17: Cash Flow Projections	145
Chapter 18: Daily Cash Position.....	153
Chapter 19: Managing Receivables and Payables.....	161
Chapter 20: Treasury Management Services	173
Part V: Data Mining: Information Management, Analysis, and Reporting.....	183
Chapter 21: Information Technology Decisions	185
Chapter 22: Ode to Excel	195
Chapter 23: Executive Reports and Performance Analytics	203
Chapter 24: The Importance of Segmental Analysis	215
Chapter 25: Ad Hoc Reporting.....	223
Part VI: Accounting by the Book.....	229
Chapter 26: Clean Books and Compliant Statements	231
Chapter 27: Accounting Cycles and the Structure of Financial Statements	239
Chapter 28: The Most Important Statement: Cash Flow	245
Chapter 29: Choose Your Auditors Wisely	251
Chapter 30: What Guarantees Fast and Painless Audits.....	257
Part VII: Risk Management	263
Chapter 31: Insurable Risks	265
Chapter 32: Commercial Risks	271
Chapter 33: Tax and Regulations Compliance	279
Part VIII: Ensuring Your Going Concern: Strategies, Plans, and Forecasts	285
Chapter 34: Principles of Strategic Planning.....	287
Chapter 35: Practical Modeling and Forecasting.....	297
Chapter 36: New Ventures.....	307
Chapter 37: Exit Strategies	315
Part IX: Administration: The Organization of People	323
Chapter 38: Acquisition of Human Resources	325
Chapter 39: Managing Human Resources.....	333
Chapter 40: The Behavioral Approach.....	343
Index	349

Introduction

What It Takes to Succeed as a CFO, or How Long Is Your Hat Rack?

In the past ten years, quite a few business books and articles have come out with demands for CFOs and controllers to reinvent themselves. The authors implore us to stop being bean counters and refashion ourselves as strategists and tacticians. We hear the same call for dramatic changes from speakers during conferences and professional gatherings. It resonates deeply among us. Oh, how we long to rise above our daily routines and into the realm of meetings with agendas full of abstract conceptualizations.

Well, that is all the time we have for dreams. Let's get back to Earth, roll up our sleeves, and attend to the reality. This book is not for *Fortune* 500 CFOs with hundreds of subordinates to whom ordinary tasks and even implementation of new ideas can be delegated. This book is for those professionals in financial management—CFOs, controllers, treasurers, VPs, and directors of finance—who, like me, toil to ensure the commercial survival of small and midsize businesses.

I don't mean to say that strategy and tactics are not on our lists of priorities. Neither do I imply that our scope of responsibilities has not changed in the last decade. As a matter of fact, I believe that CFOs and controllers in smaller businesses have experienced a more significant transformation of their roles than those in large companies. As the business climate changes, small and midsize companies struggle harder than ever for survival. That imposes even more demands on our positions. Yet the reality of our work environment does not allow us to drop any "old" tasks from our scrolls of duties. Instead, we take on more functions and expand our span of command.

Thus, it is not the reinvention of the job, but the functional diversification that assures the successful performance of a hands-on financial leader. This broad functionality is the central theme and the subject of this book. Whether you have just been promoted and it is your first time at the top of the corporate accounting and finance department, or you have worn these shoes before and

have years of executive experience, you will find the streamlined concepts helpful. This is not an academic text, nor is it a compilation of theoretical information from popular resources. The material is based on practical knowledge and hands-on experience. It will provide you with comprehensive guidelines regarding the most important functions under your control—the areas of expertise where you must excel and achieve your best.

Smaller enterprises commonly have to deal with limited resources, and that translates into slimmer organizational structures and smaller teams. In this environment, the hands-on approach becomes mandatory. CFOs and controllers must know all the functions intimately and cannot avoid tending to some tasks firsthand.

Business owners and chief executives—frequent agents of change in their companies—will find this book useful as well. It can help to formulate expectations for senior financial managers, who are entrusted with the most expensive resource: money.

A person who has achieved a top financial position in a business organization must possess expert knowledge in a variety of technical disciplines related to finance and accounting. Moreover, your books still need to be in order, you cannot escape dealing with banks, and your formal financial statements still have readers. However, all that is not enough anymore. To succeed as a CFO or a controller, one must possess sharp commercial acumen, understand all aspects of corporate management, and, yes, be a strategic thinker. A person in such position will wear many hats, handling duties that recently were not in the job description.

Whether you installed a hat rack by your door or store your hatboxes under your desk, one thing is guaranteed: your list of duties requires you to wear many hats and to change them quickly as your workday progresses. You may have started the day at your desk in your business suit, but here you are in a policeman's cap enforcing civility in human relations; and there you are in a Napoleonic bicorn developing global expansion strategies; next in a deerstalker using your forensic skills in search of a lost container; now in a geeky, propeller beanie discussing upgrade requirements with your IT staff; then in a barrister's wig reading a legal brief; and so on. The smaller the company, the larger the hat collection.

We must embrace this *functional diversification*. It is a natural result of a financial manager's evolution. Here's why:

- Human resources are related to payroll, which is not only a monetary concern, but also frequently the largest budgetary constraint.

- Accounting modules usually make up the largest portion of an IT system. Hence we have vested interests in their adequate development.
- Business strategies are fueled by cash flow, investments, and lending. You are indispensable to the executive strategists.
- Our performance analysis provides indicators as to whether the business has an ability to expand, or must contract immediately.
- Dynamic development is the key to commercial survival in today's complex markets. As members of executive teams, we must facilitate forward progression while installing proper provisions to cover all associated risks.
- All banking, customer, vendor, investment, financing, leasing, and even employment relationships are entangled in contracts, which we need to fully understand for compliance and proper procedural implementation. An ability to cut through legalese into the essence of these documents requires sufficient familiarity with both the form and substance of such instruments.
- In businesses where products have dollar signs in front of them (such as asset management or financial services), operational management becomes one of the financial responsibilities as well.

Only large enterprises can afford to have VPs for every separate group of functions. In smaller companies, functional concentration of any position is much higher, especially that of a head of finance.

They say small business is the backbone of the economy. Well, if that's true, then we are the spinal cord inside those vertebrae. We carry our load and support our employers by attending to the multitude of these functions, wearing different hats and juggling 30 balls at a time. Personally, I would not have it any other way. This is how we make our impact. This is what defines us as professionals.

Scouting Your Surroundings and Defining Your Mission

It is important to grasp the general characteristics of small and midsize businesses, which determine their organizational environment. As a head of finance, you must fully understand the nature of your position, your place within the organization, and the expectations of your bosses. The crucial tasks of identifying the key functional sectors of your responsibilities and studying essential specifics of your employer's business are prerequisites of your professional success.

What Is Special About Smaller Businesses?

According to the US Census Bureau's data, there are nearly 6 million companies in this country with less than 100 employees.¹ Besides their relatively small size, the most essential characteristic they have in common is how different they all are. Even those operating within the same industry and competing in the same markets display an array of entity setups, organizational structures, and corporate cultures.

It is only natural. The majority of these companies are entrepreneurial in their origins. They are frequently born out of ideas generated by one person or a small group of collaborators. If the founders manage to hold on, the company's development follows a unique path influenced by a multitude of forces specific to that organization.

Except for those operating in a few regulated industries, the way these companies conduct business is not monitored by external agencies. Many of them remain privately held, and therefore don't need to comply with SEC rulings or legislative acts. Those employing less than 50 people benefit from friendlier labor laws. In other words, each is free to develop into a one-of-a-kind establishment.

¹ U.S. Census Bureau, "Statistics of US Businesses," www.census.gov/econ/susb/, 2008.

Still, there are certain typical organizational attributes that can be identified in all small and midsize companies. These common factors impact and shape all functions and positions, from receptionist to CFO and CEO.

Flat Organizational Structures

Large companies usually have multilayered management hierarchy with executive (a.k.a. upper), senior middle, junior middle, and supervisory echelons. Each rank is further divided by functions, groups, tasks, and so on. There are hundreds of people with the words *vice president*, *director*, and *manager* in their titles. These are Egyptian pyramids of organizational design.

Smaller companies are not able to take advantage of economies of scale and absorb large overheads. As the result, they are characterized by much *flatter organizational structures* with fewer managerial levels. I have seen companies with as many as 80 employees and over \$200 million in revenue operating without middle and supervisory managers. This brings executive management much closer to the frontline staff.

A fiscal group composition largely depends on the company's size, the nature of its business, and the number of functions required to carry out its operations. It can range anywhere from one person holding a controller title and covering all receivable, payable, and general ledger tasks by herself to fully developed accounting and finance departments with middle management and staff in international offices. Ideally, an effective structural arrangement should leave no blind spots in functional coverage, and assure nondiscriminatory workload for all employees without unproductive or idle time, while fitting within your budgetary constraints.

Figures 1-1, 1-2, and 1-3 show generalized examples of what I find to be popular setups of financial chains of command for small, small-to-medium, and midsize companies.

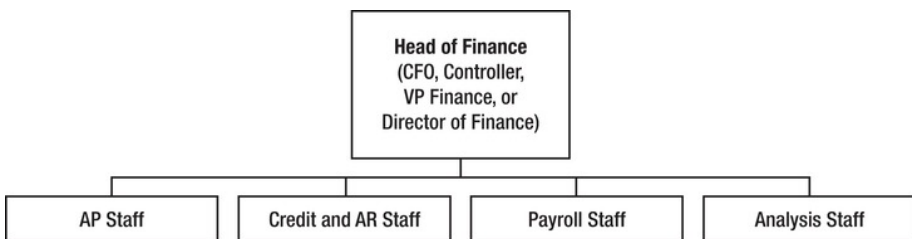


Figure 1-1. Financial functions structure typical for a small company

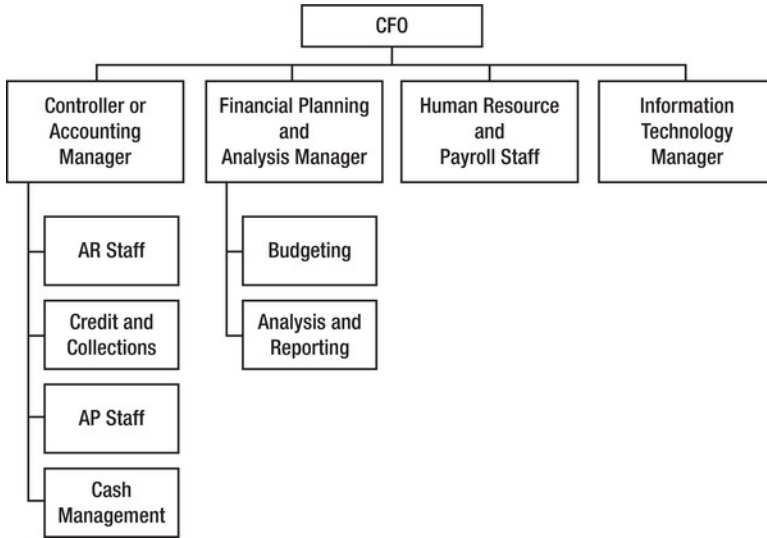


Figure I-2. Financial functions structure typical for a small-to-midsize company

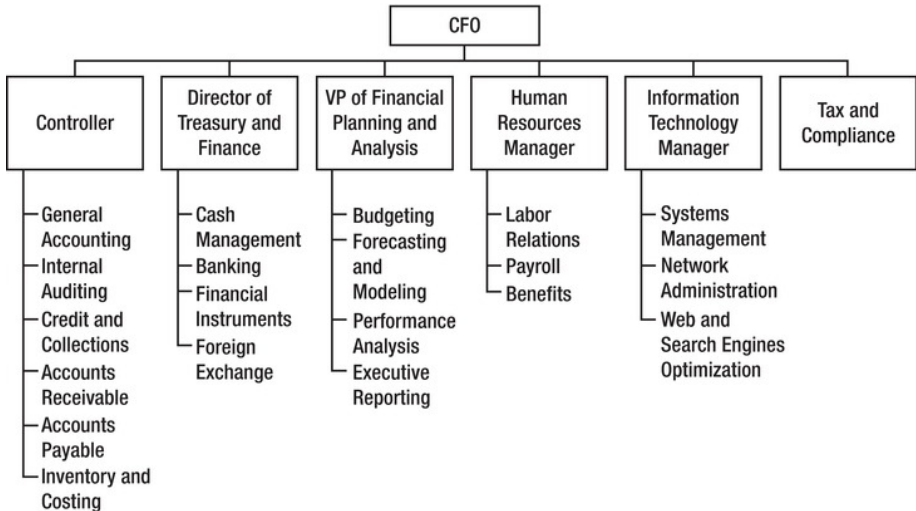


Figure I-3. Financial functions structure typical for a midsize company

■ **Note** Keep in mind that, depending on the needs and availability of funds, the lower divisions may consist of a supervisor with subordinate staff, or one staffer, or a person with managerial qualifications without subordinates. Frequently, there is no one to man the function and its execution falls to the direct responsibility of the manager who oversees it.

High Concentration of Duties

These flatter and leaner structures, with smaller supervisory staff, result in a *higher concentration of controlling duties* in the hands of executives. It applies not only to us, the financial heads, with our numerous tasks and endless supply of hats—every member of a small company’s upper management attends to multiple functions.

The VP of operations controls procurement, supplier/vendor relationships, production, distribution, logistics, storage, support, and all related technologies. I use the term *production* here in a much broader sense than manufacturing. Products, processes, or services, whether manufactured, created, or traded—whatever generates the company’s revenue—are at the center of operational management’s concern.

The head of sales and marketing is responsible for the sales force and its tactics, customer support, marketing strategies, and advertising campaigns. Nowadays, Internet visibility has become one of the most important marketing tools for a lot of businesses. There are new forms of online advertising sprouting up almost daily—social networking, Google products, and more. This executive has to be on top of all innovative developments.

Contrast this with a big company. It’s similar to when you watch a big studio production movie and the credits at the end take up to six minutes to roll. Teams upon teams of people, each responsible for an individual task, are listed.

On the other hand, when you go to see an indie movie made on a shoestring budget, the credits don’t take too much time. It’s often something like “Written, Directed, and Produced by Mos Dedicated. Camera, Light, and Sound by Nyfa Pal. Finances, Accounting, Legal, Gaffer Services, and Catering by Best M. Ever.”

That’s one of the primary differences between a large and a small enterprise. The intensity of having all these functions under one’s control is daunting and exciting at the same time. It makes us very, very busy, and that’s not even the end of it.

Hands-On Management

In a large company, the higher you are in the corporate hierarchy, the smaller the number of your direct reports. In smaller companies, however, in the absence of extra managerial padding, CFOs and controllers command a mix of middle and junior managers, as well as staffers, who report to them directly.

The firsthand familiarity with individual tasks performed by your immediate subordinates is one of the most important managerial traits in the flat organizational environment. Your position makes you a single source for expert advice, judgment calls, procedural guidance, and problem resolution. The expediency of your decisions is crucial. You need to be proficient in all functions under you in order to be a successful CFO or controller.

■ **Note** I define an expert as someone who is not just knowledgeable in a particular area, but also capable of coming up with correct solutions in the shortest possible time. When you have acquired sufficient experience in a matter, an answer should form in your mind almost subconsciously.

One has to differentiate between hands-on management and micro-management, though. The latter is out of the question. Efficiency must be your highest priority. You will be able to achieve it only by balancing a hands-on managerial approach and the appropriate delegation of duties.

When budgetary constraints leave some of your functions unmanned, you roll up your sleeves and attend to them yourself. Active participation in daily routines is not unheard of for CFOs and controllers, even in midsize companies. In small companies, it's commonplace. I am sure many of you design reports, create models, cut checks, make general entries, and execute wire transfers. Frequently in small companies, a controller or an accounting manager is a one-person show altogether, doing everything herself. In any case, I've always believed that executives should know how to do the job of every person who reports to them directly or indirectly.

There are some popular workplace sitcoms on network television right now. Once in a while, when I am on a plane, I watch an episode. The funniest thing about these shows for me is how much free time the management has. Then again, they are typically employed by huge organizations and they are very hands off. We, on the other hand, take charge and take part; our every minute is filled with hard work.

The Owner's Proximity

Having the owner of the company as your active CEO and your immediate boss is a blessing and a curse.

On one hand, this is what we call a high-visibility position. There is nobody between you and the person who is ultimately responsible for assessing your performance and rewarding you for your efforts. It also heightens your sense of responsibility, as you should always be conscious of the fact that whatever you do affects the wallet of a person you see every day. Some people, weighing pros and cons, may place this factor into the bowl of disadvantages, but I consider it a positive ingredient of professional development.

On the other hand, this places you face to face with a person who

- is afflicted by an entrepreneurial bug (i.e., wants everything to be done yesterday);
- has most likely never been an employee and doesn't understand what it means to be one; and
- has a racing, idea-generating mind and allows for no implementation time.

I am sure you can continue this list yourself. The bottom line is that dealing with the boss is stressful, sometimes frustrating, and unavoidable. A constant effort to make the best of it is an integral part of the job.

Here is another important aspect of boss's proximity. Some people think that politics are prevalent only in large bureaucracies. In reality, it has nothing to do with the organization's size. It's the human factor: people are people. Beware of backroom campaigning in small and midsize companies. There is no corporate ladder to climb, so everyone vies for the same spot—at the right hand of the boss. When you are a CFO and the owner is your CEO, you've reached the highest attainable position in the company. This doesn't mean, however, that your opinions or ideas will not be undercut by your executive peers or even insubordinate staffers.

■ **Tip** Everyone develops his or her own coping mechanisms for handling the stress of a fast-paced, hands-on environment. The best thing you can do is to be prepared for it. If you know that this is the reality of your daily life, there will be no discouraging surprises. Just deal with it as an ordinary course of business. One of the useful devices is self-organization, discussed in Chapter 3.

Titles vs. Job Descriptions

The flexibility and informal genesis of organizational structures in smaller companies make the idea of managerial titles, in all practical senses, irrelevant. The designation printed on your business card is frequently influenced by such random matters as traditions, your own seniority with the company, the owner's whim—considerations that have nothing to do with your scope of responsibilities or level of authority.

In many instances, your title is the reflection of your boss's respect and appreciation of your efforts. You can learn a lot about a business owner by recognizing what significance he places on a particular title: his reluctance, for example, to bestow an executive title on somebody other than himself, or on someone who has been working for him for a long time and started at a much lower level.

As a result, financial professionals working in small companies may hold different titles while performing exactly the same set of duties. I have known controllers who occupied their positions for ten years, and after leaving the company were replaced by CFOs without any changes in the functional responsibility.

Sometimes a title is just a title. You may get promoted into it as a token for the years you have spent with the company, but there are no new mean-

ingful professional challenges and no changes in the quality of your duties or the compensation scale. One cannot call such title progression successful. Personally, I have always believed that they can call me whatever they want: a hey-you, a firefighting exec, or a clean-after-everyone lady, as long as I can continue to impact the business in the most profound way, implement ideas of highest sophistication, keep a tight rein on all activities, and receive rewards reflecting my influence on the company.

It is the *job description* that really matters. What are the functions you control? Which tasks are you expected to cover? What is the scope of your executive authority and the range of your autonomy? Are you expected to participate in strategic and tactical decisions?

I am not going to bore you with dictionary-based definitions. Yet, since every job is a line on a resume, and because it may help as a bargaining tool in the next raise negotiation, you may find useful the following informal correlation between actual job descriptions and commonly used titles. It may also help those people who were given a title without a job description—this happens more frequently than one may think. The boundaries of control will expand from title to title as we move through the following sections.

■ **Note** Even though the predominant notion here is that the title-holders oversee accounting and finance departments in their companies, the descriptions could be applicable to the subordinate managers as well. Also, keep in mind that every subsequent position must cover all functions listed for the previous one.

Accounting/Finance Manager

There are further variations of this title: accounting manager, finance manager, accounting and finance manager, and so on. Sometimes the word *senior* is added. Regardless, it is expected that the entire system of accounting and treasury tasks supporting the business's daily operations, as well as periodic reporting, are supervised and/or performed by this person. The following are the main areas of controlled duties:

- All tasks related to AR (billing, credit, collections, and receipts) and AP (payable entries, schedules, and payments)
- Payroll and benefits administration, including payroll taxes
- General ledger transactions (including fixed assets, financing and capital transactions, adjustment entries, etc.—whatever is applicable to your business) and accounts reconciliation

- Daily treasury activities, including cash position and requirements reports, deficit/surplus assessment, and banking
- Monthly bank statement reconciliation
- Monthly/quarterly/annual closing procedures, including accruals and prepaids, cost of goods sold (COGS)/ inventory valuations, capitalization, reserves, payroll, commissions, depreciation, and amortization
- Monthly internal financial statement preparation
- Revenue, expenses, and profitability analysis and reporting
- Quarterly and annual trial balances and supporting documentation for reviews, audits, formal financial statements, and tax returns
- Hiring, training, and supervision of staff

Director of Accounting/Finance

I have met some private business owners who mistook the financial director's position as more senior than that of a controller. In Europe, for example, Director is frequently the highest available title. In the United States, however, a director is usually understood to be a manager of managers. In larger companies, controllers have several directors reporting to them. In practical terms, the functions of higher organizational importance must be added to the scope:

- Budgeting and variance analysis
- Treasury management and cash flow projections
- Business intelligence and performance analytics
- Accounting research and standards/pronouncements compliance
- Human resources (HR) management

Controller

This is the most prevalent and familiar title for the senior accounting and finance person in a flat-structured organization. Even a start-up company will employ a controller at the very beginning of its life cycle, so that all initial recording and reporting functions, as well as all subsequent tasks, can be properly initiated, developed, and kept under control. The controllership brings into the picture the responsibilities for integrity, compliance, and efficiency of the company's fiscal structure:

- Policy and procedure development and control
- Internal controls and auditing

- Cost and profitability control
- Independent audit management
- External financial reporting
- Taxation
- Information systems decisions and management

Vice President of Finance

This title, even though very appropriate for a large conglomerate, is somewhat strange in a smaller company. Yet, it is very popular. Strictly speaking, a VP is a subordinate of a president, who in turn reports to a chief executive officer. However, in many companies, president and CEO are merged into one person, who obviously prefers the most prestigious title. Here is a familiar example: Facebook's founder and 24% shareholder Mark Zuckerberg is officially listed as the company's CEO/president. However, in most publications, articles, and interviews, the word *president* is habitually dropped.

The point is, if there is no president per se, how could there be a VP? Yet, there are plenty of VPs of marketing, sales, operations, and so on, reporting directly to the CEO. Most of the time, the intent behind assigning the VP title to the person in charge of the company's accounting and finance is to equalize her level of authority with the other VPs. This position's responsibilities usually expand further into capital and finance areas of expertise:

- Capital structuring and resourcing
- Lender and investor relationships
- Business development forecasting and modeling
- Commercial risk management, including foreign exchange, commodity, and interest rate hedging
- Insured risk management

Chief Financial Officer

This is the big kahuna of financial management—a member of the C-level executive rank. Ideally, at this stage, you become the CEO's partner in assuring the company's successful development and survival. Your duties should combine the responsibilities for the company's financial well-being and the business's strategic advancement. The following concerns must be added to the long list of functions we have accumulated so far:

- Tax and regulation compliance

- Economic, political, and business environment analysis and forecasting
- Viability assessment
- Commercial development planning, including diversification, expansion/contraction, international sourcing/ distribution, and so on
- New venture evaluations and setups
- Acquisitions due diligence
- Strategic planning and implementation, including foreign entities, outsourcing, restructuring, and exits

■ **Note** Remember, whether you have several fully staffed departments under your control or you are all alone, as long as you attend to all the CFO's tasks, you can consider yourself one, regardless of your official title.

The CFO's Mission and Aspirations

Let's face it, the main reason why people go to work every day is to provide sustenance for those who depend on us, including ourselves. Maslow's Hierarchy of Needs (see Figure 3-1) is unbeatable: roof over your head, food on the table, clothes on your back, and safety always come first. However, there must be a reason for the chart to have this particular shape. As we climb up the mountain of expertise, enrichment, and vocational advancement, after a certain point we pass into more elevated regions of wants.

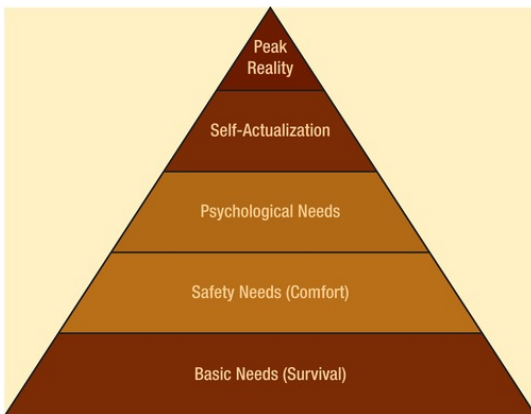


Figure 3-1. Maslow's Hierarchy of Needs

Even if leading financial functions in a small or midsize business is not perceived as a pinnacle of one's life by the majority of people, we can definitely agree that *self-actualization* is a big part of our striving for higher professional status. We seek to make a difference, to leave our personal imprint on the company's prominence, and to achieve results, which give us that priceless award: the sense of self-respect. For me personally, it has always been important to live up to my own professional standards and ethics, even if nobody else acknowledges it.

All CFOs must define for themselves the *higher purposes* of their work efforts, those that go beyond the material necessities: their professional mission and aspirations.

Your Mission

If I had to express it in just one sentence, I would say that the mission of CFOs is to *utilize their best abilities and partner with other senior managers in facilitation of the company's commercial survival, stability, and growth.*

Ideally, the pursuit of this purpose will bring not only the moral satisfaction of doing something valuable, but will coincide with your personal goals of professional development and merit-based rewards.

By ensuring commercial progress and the viability of our employers, we provide ourselves with the opportunity to grow further with the company. We also get a chance to affect the lives of other people both within and outside of the organization: employees, suppliers, customers, lenders, and many others who depend on the business not to fail.

Your Aspirations

While mission is a singular aim, you can aspire to multiple achievements and accomplishments, which become integral parts of that overall ambition. Everyone may have their own, and they can be very general or broken down into individual stepping stones. I have formulated four main aspirations, which are relatively broad and encompass many individual efforts. I find them useful because they help to keep my professional activities in perspective.

Free Your CEO

Many small and midsize businesses are privately held with owners assuming the position of CEOs. Frequently, they are the very entrepreneurs who conceived the idea and, against all odds, implemented it by establishing the

company, producing products or services, and creating job positions, including the one you hold. That alone deserves an ode to courage.

Whether the CEO is the founder, an heir, or an appointed exec, as the head of finance, you must stand by his shoulder, fighting the daily war of commercial survival. Most importantly, it is your job to promote the boss's ability to attend to his primary responsibilities—the generation of new ideas, business development, strategic initiatives, and executive decision-making, all of which will ensure that the company prospers and grows.

To achieve that, you must free the CEO from involvement in any matters that you and your peers have authority to resolve and control. Your boss should be able to forget that the tasks under your management even exist. As his strategic partner, you cannot afford to let him spare a thought on issues in the realm of your own functionality. If he does that, he is not thinking about new markets, products, distribution channels, or organizational improvements. And when ideas are formulated, analyzed, and approved, we are obligated to make sure that all supporting elements—financing, structures, and control procedures—are in place.

I don't let my CEOs be bothered by bankers or vendors; I don't allow them to fiddle with numbers; I don't ask them to learn computer systems. In fact, I even prefer them not to know Excel. Here is an example of what I consider great executive support: Radiohead's frontman, Thom Yorke, cannot read sheet music. For 25 years now, his classically educated multiinstrumentalist bandmate, Johnny Greenwood, has deliberately resisted teaching Thom musical grammar out of concern that it may diminish Yorke's creativity. We should all aspire to such an attitude.

Transform Your Role

Even though I employed a bit of sarcasm when I was talking about the "CFO's reinvention" movement in the Introduction, I rigorously support the idea of our role's transformation. I emphasized that new activities, not too long ago unknown to senior accounting and finance management, still must be added to our functional rosters.

The truth is that many accountants don't help design and produce products or services; most of the time they don't participate in operational efficiency improvements; they don't source the cheapest materials or engage the best logistics; they don't find markets, nurture customers, or push products at the best prices. Way after all these actions take place in the value chain, old-fashioned bean counters, in the most passive and reactionary way, close the

numbers and then report on results in formal statements that have no chance to cause any changes or affect the bottom line.

This is not acceptable in today's environment. CFOs and controllers must become active agents of their companies' commercial process and engage in activities that impact profitability with a magnitude comparable to the best procurement, production, and sales practices. Business strategy development, benchmarking, economic assessment, tactical modeling, real-time performance analytics, and risk management are among the important value-added tasks that can bring about powerful positive consequences.

By making themselves integral parts of the value chain, financial professionals accomplish their mission as growth and stability facilitators and boost their worth.

Professional Growth

Even when your diligent work efforts and loyalty assure your success in your current position within the company, never rest on your laurels. You must continue your professional growth in two ways.

First of all, expand your scope of responsibilities beyond your original job description. If you find functional deficiencies at your employer and you think that they hold the business back, don't hide from additional work—formulate new tasks and implement the change. This will enhance the quality of your position.

Secondly, keep abreast of all developments related to the functions under your control: the new features released for your system, a report writer that has just been developed, new treasury instruments offered by your banks, and so on. Otherwise you will be left behind.

In the summer of 2004, my bankers at the time, knowing my interest in all new things treasury related, invited me to participate in the Wachovia Bank Conference on the Check 21 Act that had just been put in force. That was how I learned about remote deposit capturing. As a result, my employer was one of the first clients to take advantage of a check scanner, improving cash flow management.

Keep Your Sanity

Somebody at work once gave me a magnet with a crazy-looking person behind a desk and the caption, "Not another crisis! My schedule is full!" It

would be funny if it weren't so true. We cannot deny the fact that trying really hard to advance the mission frequently leads to feeling overwhelmed and frustrated.

We must resist and keep ourselves sane, or we will fail. And the secret, I believe, is in prioritization and time organization. There are tons of books written on these subjects. I just want to share a few thoughts and rules I have established for myself.

Prioritization Rules

Rule #1: Assign priority scores to each task. The highest priority on your list should always be given to the task that in a long run will benefit the bottom line the most.

Rule #2: Designate time for periodic tasks of high priority in advance. There are such things as bank reports, monthly budgets, weekly cash flow projections, and so on, that occur periodically. Prevent yourself from cramming at the last moment by scheduling these tasks ahead of time.

Rule #3: Be flexible. Don't get paranoid about the schedule you have created yourself. If something urgent comes up, be prepared to reshuffle your list.

It is amazing what a little adjustment in time organization can do for you. Even with all the unexpected emergencies and endless interruptions, I try to assign time limits to all parts of my daily routines. Not only does it allow me to move along from task to task, but it also frequently results in efficiency improvements. If something takes an unreasonably long time to execute, it means the process needs to be redesigned.

One of the most time-consuming and disruptive factors of business life today is e-mailing. I have established rules for that too. I do not drop everything to answer an e-mail that just arrived into my inbox. Everyone I deal with on a regular basis knows that I answer my messages twice a day—first thing in the morning and at 4:00 p.m. If their chairs are on fire, they can always call me.

Eight Balls You Must Keep in the Air

The variations of monetary concerns, recording specifics, and reporting objectives in individual businesses are astronomical. Yet, there are *eight core functional sectors* that are building blocks of the accounting and financial management framework in every organization. They are absolutely essential for stable operation and successful growth. So, like a juggler, you must keep these balls in the air and your eyes on them at all times. Depending on the industry and the company's nature, the practical impact of each group of activities may differ. However, in one form or another, they are fundamental components of the responsibilities of CFOs and controllers.

Separate parts of this book are devoted to features pertaining to each functional group and the related duties of senior financial management. For the time being, let's discuss what makes these responsibilities so crucial.

Policies, Procedures, and Controls

There is a wonderful simile we use to describe something steady and dependable that progresses without any problems. We say, "Runs like clockwork."

The reason a high-quality watch can be used as a standard for an untroubled undertaking is that it is built in accordance with precise rules that were invented centuries ago and have been honed ever since. Furthermore, if we operate and maintain it as recommended by the instruction manual, it will serve us for many, many years. Some special watches are even passed on from generation to generation.

We would all like our organizations to run just as smoothly, and this is the very first step on the way to continuous and efficient workflow. When a company's policies and procedures are properly developed and implemented, the business machine runs smoothly according to the general rules of movement, and is similarly honed over time. Without such a system of regulations and instructions, the business runs like a chaotic, unmanageable, and feverish organism. Control processes serve as measures that prevent violations and assure proper execution of this internal legal code.

Capital Resources and Banking

In the vast sea of commerce, the most lucrative business is selling money. Banks, financial institutions, hedge funds, and equity investors take risks by placing money from their pockets into someone else's in the hope of big returns. It is business like no other business (not even show business), but it still abides by the basic economic law of supply and demand. The reason funds are offered on the market is because there is an incredibly high demand for them. Money is the fuel of the business machine. No company can function without capital, whether it is borrowed, invested, or even its own equity. Its timely acquisition, proper care, and correct utilization are integral means to accomplishing your mission as a head of finance.

Cash Management

Securing funds from outside sources in itself does not guarantee that you can meet your monetary obligations on daily basis. Careful planning and persistent efforts, including management of operational inflows, structuring of external relationships, engagement of innovative banking instruments, and design of specific organizational tools are all required. There is a lot of work to be done to ensure that you never halt business operations because you run out of cash or its equivalent.

Information, Analysis, and Reporting

The importance of information as one of the primary business resources is a notion so prominent in our minds that it almost sounds banal. This postulate is taught in schools, featured in periodicals, and discussed on Internet boards. Yet, in smaller companies, time after time, you observe environments nearly devoid of managerial reporting, commercial intelligence, and even the most elemental analytical tools. It is an unfortunate fact that there are organizations losing market share, revenues, profits, and liquidity without even realizing it until after the fact. Far more frequently than we would like to admit, lack of just-in-time information becomes a reason for a commercial downfall.

Accounting Management, Financial Statements, and Audits

We cannot say for sure just when the ingenious canons of double-entry bookkeeping were first formulated. The earliest proof of its practical usage was found in Florence and dates to the beginning of the thirteenth century. At the peak of the Italian Renaissance, in the fifteenth century, prominent mathematicians found it necessary to include the so-called Venetian method of bookkeeping in their treatises, including the 1494 *Summa de arithmetica, geometria, proportioni et proportionalita*, by Fra Luca Bartolomeo de Pacioli—the first published book containing a section on accounting. Pacioli's 36 chapters describe the full accounting cycle ending with the trial balance (*summa summarium*), which lists debits on the left side and credits on the right. When the totals of the two columns are equal, the books are balanced.

It is not surprising that mathematicians were at the origin of the basic rules still employed by professionals in charge of keeping financial books and records everywhere on the globe—after all, they were teaching the world how to count. It is also apparent why it was the Italian scholars who turned their attention to the subject. At the time, Venice was the greatest maritime power and the largest commercial hub. Venetian merchant marine companies that sent their vessels across the seas for silk, grains, and spices needed a common “language” to keep accounts of their dealings with shipbuilders, financiers, sellers, and buyers in order. They needed methods that would deliver clarity to their records and keep everyone on the same page.

No matter how complicated today's Generally Accepted Principles (GAAP) and International Financial Reporting Standards (IFRS) have become, the fundamental principles of bookkeeping and formal presentation of fiscal data

remain unchanged. This universality of accounting standards makes them the common ground for everyone interested in assessing your company's financial standing, whether it is your local banker or an individual investor on another continent. I cannot overemphasize how important it is to know and properly follow the established guidelines for translating business events into ledger entries and producing financial statements that accurately reflect the results of your business activities.

I, for one, adore the unbeatable logic and streamlined beauty of accounting principles. Their mathematical clarity unites all financial professionals around the world; they are our Esperanto.

Risk Management and Compliance

The increasing complexity of the current business environment with its global dependability, volatile financial and commodities markets, unpredictable demand deviations, and abrupt political changes is the common denominator of all operating entities, regardless of their industry or size. Recognizing and minimizing the risks associated with your company's daily activities is an integral part of your responsibilities as an organizational manager.

What's more, whether you have worldwide exposure or are fully enclosed in one locality, you are subject to the laws and regulations of various agencies, governments, and jurisdictions. They are always complicated, frequently confusing, and sometimes overlapping. Taxation—international, federal, state, and local (including foreign)—may be the most obvious and vast area, but it's far from the only one of these concerns. Violations of the legal rules put businesses at high risk of monetary and administrative sanctions and may cause their downfall. Such violations should be prevented at all costs.

Strategic Planning

With increasing frequency, we encounter within job descriptions for CFOs and controllers requirements such as “partner with CEO,” “support CEO,” “take part in executive decisions,” and so forth—especially in entrepreneurial companies. Just look through the job boards' listings. We can say that all our functions are intended to support the boss. However, these demands go beyond day-to-day accounting and finance.

If the CEO's job is to grow and advance the business for the sake of its survival and prosperity, your collaboration translates into an alliance with this cause and direct participation in its promotion. Senior financial executives

today are expected to possess and apply considerable commercial acumen. Your active contribution into evaluation of opportunities, development of strategies, scenarios modeling, tactical planning, and implementation process signifies your transformation into a business executive.

Administration and HR

This functional sector encompasses more than common payroll and benefits handling. HR, if properly trained, developed, nurtured, and retained, constitutes one of your organization's most valuable assets. HR functions provide a CFO with a unique opportunity to influence the organizational culture in a positive way.

The Essential Knowledge Prerequisites

By now you should have some general ideas about typical characteristics of your environment, your own role and purpose, the expectations of others, and primary routes for channeling your talents and efforts. It is time to study the specific aspects of your surroundings and draw a detailed map that will help you on your journey.

This is a mandatory activity for a recently hired head of finance, new to a company. It is also a good idea for someone who has been with a company for a while in a lower position and has just been promoted—a new vantage point may provide you with the better vision of your company. Even if you've held the top post for a few years, but never got around to doing this and feel that the incomplete picture prevents you from excelling, maybe now is a good time to go back to the drawing board.

This is your R&D stage, necessary for the proper functional design of your job. Your research will help you to improve future performance. Every CFO and controller must acquire an exhaustive understanding of their employer's business. There is no doubt that compiling what I call *the big picture* is the

key element in your strategic responsibilities. However, it is just as important for day-to-day hands-on management. In the absence of thorough knowledge of all operational and organizational features, it is impossible to construct budgets, define tasks, or determine reporting requirements.

At the very least, your information-gathering activities should be focused on the following four areas.

Study of Corporate Structure

Economic complexity pushes businesses into multiple levels of diversification—wider product ranges, additional services, new geographical and demographic markets, related industries, outsourcing, foreign productions, and so on. As companies pave new ways to conduct business, their corporate structures adapt accordingly: branches are created, subsidiaries are formed, and satellite offices are opened. Today, a \$10 million service company may turn out to be a surprisingly complicated organism. These structural developments affect nearly every accounting and financial function: local taxation, intercompany transactions, principles of consolidation, financial statement disclosures, and banking facilities, just to name a few.

Let's say you have taken a CFO position in New York. Through the interview process, web site information, and a couple of initial meetings, you have found out that, besides the New York City headquarters, the company has a presence in Houston, Texas; Buffalo, New York; Columbus, Ohio; Shanghai, China; Amsterdam, the Netherlands; and Istanbul, Turkey. Is this knowledge sufficient for you to define your actions with respect to each location? The answer is no because this geographical lineup can be translated into completely different scenarios. There are as many variations as there are companies.

In scenario 1 (Figure 5-1), for example, you have a New York corporation with three wholly owned subsidiaries, two of them overseas, plus 50% ownership in a Chinese manufacturer, and two satellite offices in different states. Four of these companies need to be consolidated into your financial statements. To highlight some other pressing issues, you have intercompany transactions in various currencies, import/export duty exposure, and an array of tax headaches, both domestic and international, including VAT (value-added tax, common in Europe).

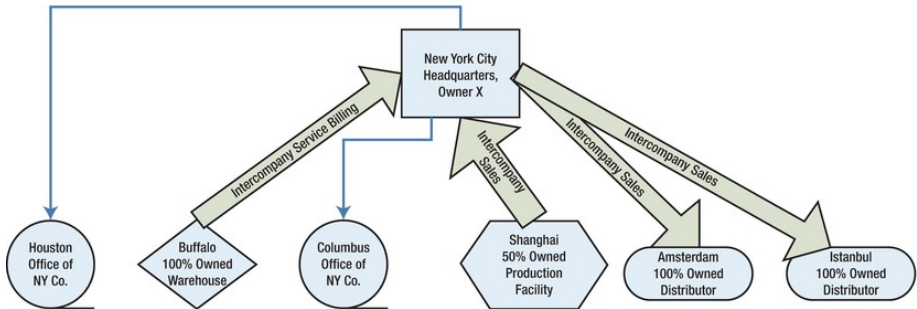


Figure 5-1. Corporate structure, scenario 1

On the other hand, in scenario 2 (Figure 5-2), you have only one foreign subsidiary to consolidate and you do not have any intercompany transactions. This setup appears to be simpler, yet there are still some important concerns you should keep in mind. Even though the New York company does not have any stakes in the Dutch and Turkish entities, they all have the same ownership. Therefore, they are considered related parties—a fact that must be disclosed in your financial statements, and most likely to your lenders and investors. Another important point is the state tax situation: even though you do not own the Ohio warehouse, it is possible that a tax return will need to be filed based on the physical presence of your goods in there.

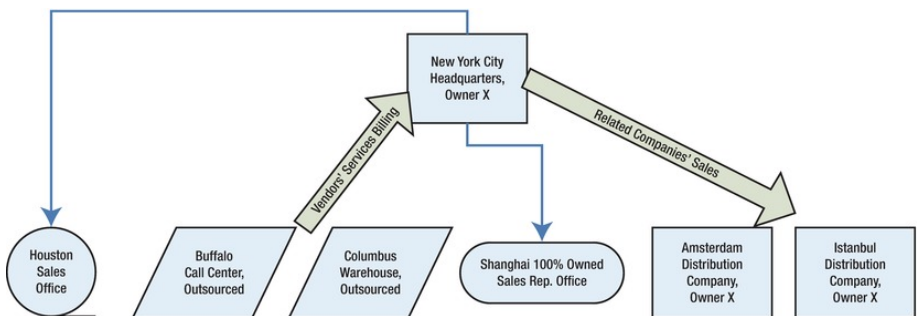


Figure 5-2. Corporate structure, scenario 2

In some small companies, the owners believe that this information is on a need-to-know basis only. It will be your job to convince them that your complete understanding of the structure will allow you to attend to the related issues and protect the business from unnecessary risks. Don't just stop at verbal explanations either. You must see corporate documents and read agreements in order to make sure that you've got everything covered.

Study of Operational Flow and Value Chain

Not only do I make my understanding of the entire business cycle from A to Z the highest priority, I also go out of my way to make sure that people in my departments have a good grasp of their employer’s operations and economic purpose. Later on, we will come back to discussing how the employees’ realization of their place within the organization impacts their morale. During your orientation stage, though, this study has immediate practical applications. It is a prerequisite to identifying accounting cycles, classifying assets and liabilities, pinpointing cost centers, determining analytical and financing needs, and more. There are transactions happening at every stage of the operational flow that give rise to accounting events. Without full comprehension of the value chain, you run the risk of oversights and errors.

What are the revenue-generating products and/or services? Do you purchase the raw materials or buy prefabricated parts? Do you have your own storage facilities or use public warehouses? And what exactly are you storing there—is it your inventory, or your supplier’s product you bought on consignment, or your customer’s goods, for which you are charging a storage fee? It would take a separate book to list all the possibilities.

You must analyze the business nature of your company, formulate appropriate questions accordingly, and get the questions answered. I have found constructing elaborate operational flow sequences or detailed value chain charts to be very helpful. A generalized version of such a chart is exemplified in Figure 5-3.



Figure 5-3. Example of a value chain chart

Study of the Organizational Chart and Functional Distribution

In the previous section we talked about processes. In this one, we'll survey people and their positions. I don't have to convince anybody that it is important to figure out the chain of command and designation of responsibilities within your employer's organization—you must need to know who's who. It goes beyond just knowing your peers with whom you discuss company-wide issues and interdepartmental relationships. You have to know people along the value chain—those who are in charge of cost and profit centers; those who have relationships with suppliers, vendors, and customers; and those who maintain your facilities and receive your mail.

For the departments outside of your managerial scope, an elaborate chart of existing people with their titles and principal responsibilities should be enough. However, for your departments, I suggest a different approach that is more function driven. It will not just help you to establish correlations between tasks and employees, but it can also help to identify your blind spots.

You can start with a structure that includes all functions you believe to be necessary and then fill in the existing staff. Figure 5-4 shows a possible outcome. The boxes without names are open positions. This can be a starting point for regrouping, new assignments, and possibly hiring.

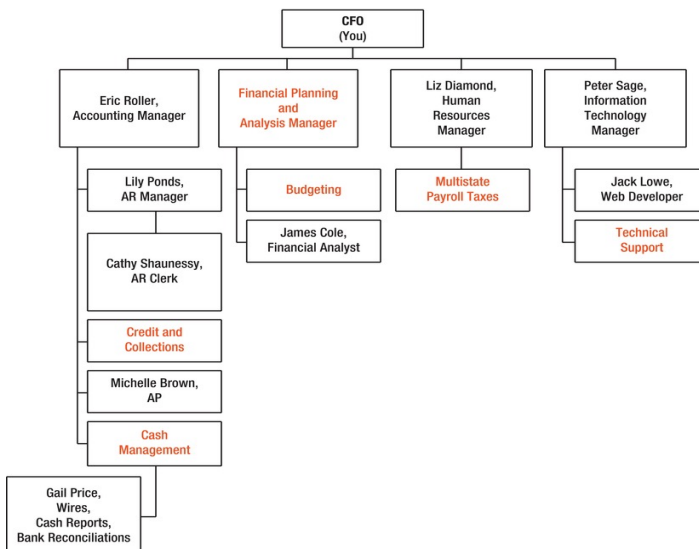


Figure 5-4. Example of existing accounting and finance functional structure

Study of Existing Policies and Procedures

If you have become a CFO or a controller in a company that already has policies in writing and documented procedures in place, even if they are deficient, consider yourself very lucky. You can study the existing papers, outline blind spots, and pinpoint weak or erroneous steps. It is easier to enforce changes if employees are already comfortable with an idea of adhering to a recorded set of rules.

On the other hand, you must be prepared to deal with a complete lack of anything in writing. The important thing to remember is that this doesn't mean policies and procedures don't exist. They are there like the oral folklore of an ancient tribe, passed from generation to generation. It would be a big mistake just to ignore the traditions and try to impose a new order. You have to uncover and learn them first.

This process will require asking plenty of questions, observing actions, and collecting documents. Interview people about their routines and the reasons they perform their duties in a particular way. Ask them to prepare step-by-step written outlines. There is a good technique used in operational management: observing workers throughout the day and recording their activities. You may consider doing this with employees responsible for the most important tasks under your control.

Make an effort not to criticize—it will put people on the defensive and make the implementation of future changes much more difficult. Try to stop yourself from effecting modifications during your discovery process—you may not find out everything you need. Don't dismiss the existing methods until you completely understand why things are done in a particular way. Many of these practices have developed naturally and don't violate any principles. It is likely you will end up adapting at least some of them.

■ **Note** Remember, you cannot afford to take weeks to complete your orientation. Your employers will expect you to attack your responsibilities as soon as you start. Recruiters and hiring executives frequently insist on prior industry experience in hopes of eliminating the learning curve, even though, as was previously pointed out, all companies differ from one another anyway. As an expert, you have the power to apply your fundamental knowledge to any type of business. If you go in prepared, with a clearly outlined plan of actions, you should be able to dissect your new professional endeavor in no time.

With your scouting exercise complete, you are now ready to embark on a quest for successful accomplishment of your mission.

Enforcing the Law: Policies, Procedures, and Controls

A company is a microcosm of a country—a nation with its own government (sometimes monarchic, other times democratic), population, sovereign territory, and “foreign” relations. Like any country, it must have the Law of the Land—a system of rules and guidelines, which shapes its internal and external activities. Well-defined policies and procedures, properly followed, ensure the company’s efficiency and effectiveness as an entity. They minimize risks and perpetuate advancement. Managing the application of the law requires persistent monitoring. Altogether, these components constitute the internal control structure with the controlling duties in the hands of financial executives.

System of Internal Control and Company Policies

There are many specific definitions of *internal control*, which take slightly different meanings depending on which group of functions is involved. At the same time, the words frequently carry a narrow meaning of the accounting and auditing discipline. Conceptually, however, the idea of internal control has a wider significance, which can be summed up in this way: *internal control encompasses all steps to be taken by a company to make sure it doesn't fail*. Even the standard accounting definition of internal control's objectives, provided in Statement on Auditing Standards No. 55, issued by Audited Standards Board of American Institute of Certified Public Accountants (AICPA), goes outside narrow professional scope and includes

- reliability of financial reporting;
- laws and regulation compliance; and
- operational effectiveness and efficiency.

Therefore, it is appropriate to use the term in its broadest context and include in the internal control structure all policies and procedures established

within an organization, regardless of which aspect of the company's activity they address.

The idea of control as an active process consists of five universally applicable components, which can be utilized in virtually any supervised structure:

- Creating a control environment, where people understand that they can rely on and must follow the system of monitored rules, which is achieved by delivering policies and procedures to employees.
- Assessing risk, which is not limited just to direct dangers, such as fraud, accidents, or violations of laws, but also includes isolating important tasks that need to be regulated to assure successful execution of a company's strategies.
- Defining and implementing policies and procedures as guiding devices.
- Developing information-processing and communication systems that digest data and enable the delivery of vital results to interested parties.
- Designing monitoring mechanisms and applied control instruments that test the conformity, efficiency, and accuracy of all parts and players in the structure.

As central parts of the internal control architecture, *policies* are fundamental principles and rules that provide members of your organization with guidelines for the course of actions to be taken under certain circumstances and assist them in making decisions. They don't actually outline the steps to follow, but instead give a general idea about the company's stand on a particular issue. It is important that policies are explicitly defined, clearly explained, and diligently adapted by everyone. A well-formed policy should be useful in the normal course of business as well as in case of extraordinary events.

Procedures, on the other hand, are intended to detail how, when, and where the described tasks must be performed. Hence, they have to be designed as a series of steps intended to take a person through the process from the beginning to the end, accomplishing the desirable results. Procedures are formulated for repetitive tasks and together comprise the methodology of how business is conducted in your enterprise.

A great thing about policies and procedures is that they serve a dual purpose. They provide employees with the support system that removes uncertainty from their daily activities and instills a sense of confidence. At the same time, as part of the internal control framework, these rules and guides

guarantee the entity's efficiency and make everyone's effort a meaningful contribution toward the company's overall goals.

Writing a good policy is hard and every detail is important. The language and style used in written policies often reflects the company's culture. Reading these documents can reveal management's attitudes toward employees and the CEO's top priorities. This is especially true in small companies. I once had an opportunity to read a set of guidelines written by a business owner. They consisted almost entirely of imperative verbs (e.g., "you must"). It is no surprise that this organization suffered one of the highest turnovers I've ever observed.

Essentially, all company policies are "employee" policies, since they are to be followed by people working for the organization. However, most of the time, an employee policy per se is understood to be a sort of code of conduct (i.e., an *HR policy*). Let's follow this convention and separate employee policies from other business policies, which are more closely associated with procedures. These I would like to divide further into two groups: those related to *operations* and those dealing with *finance and administration*.

One of the practical applications of separating an all-encompassing general business policy into groups and sections, governing different aspects of the company's activity, is that you can distribute those parts only to employees whose jobs are directly affected by the established rules.

Employee Policies

These are the most widely used policies, and the majority of companies have some sort of a document in place—an employee handbook, or a manual, or just a few stapled-together pages. Regardless of the format, they are, as a rule, intended for all employees in the company and should be formulated with that in mind. At the very least, they include rules covering the areas outlined following. Of course, depending on the company's priorities regarding the employees, there could be additions or subtractions.

Does the CFO or controller really need to worry about the handbook? Yes. As a CFO, I have personally written employee handbooks. In smaller companies, HR managers are sometimes less qualified than CFOs to write these documents. If a company cannot afford to hire someone, the CFO should be able to step in. After all, we understand policies, regulations, rules, and procedures. That said, if you are in charge of charting the handbook, it is wise to have your draft reviewed by an employment attorney or an HR consultant. It will cost less than having them design it from scratch, but will assure that the document adheres to current labor laws.

Here's a sample listing of typical topics covered in a handbook:

- Introduction
 - Management note
 - Mission statement
 - Goals and values
 - Equal opportunity statement
 - At-will employment statement
- Workplace behavioral guidelines (a.k.a. company image)
 - Work hours
 - Attendance and tardiness
 - Workplace etiquette
 - Work area maintenance
 - Premises regulations
 - Anti-substance abuse
 - Sexual harassment
 - Dress code
 - Internal and external communications
- Benefits and tenure
 - Personal time off
 - Observed holidays
 - Payroll periods
 - Performance reviews
 - Salary reviews
 - Bonuses
 - Health benefits, COBRA
 - Disability and life insurance, workers compensation
 - Retirement plans
 - Fringe benefits
 - Continuous education
- Company property
 - Personal use
 - Removal from premises
 - Equipment and furniture care
 - Intellectual property
 - Files and directories

- Proprietary information
- Security
- Safety and accidents
 - OSHA regulations
 - Emergency procedures

Benefits and paid time off (frequently abbreviated as PTO) make up the most sensitive section of the handbook. Make sure that it goes beyond just stating the number of days allowed, and spells out the rules for waiting periods, accruals, rollovers, maximum consecutive days, and so on. The benefit clauses have to be explicit with respect to employees' contributions, vesting periods, and the like.

Labor laws are less restrictive when it comes to small businesses. State labor departments leave many decisions to the employers' discretion and will refer to your written policy if there is a dispute with a former or current employee. This makes your manual even more important. A signed acceptance document should be collected from newly hired employees on their first working day. It must expressly state that they have read and understood all clauses of the handbook. By signing off, the employees also acknowledge that their employment is contingent on adhering to the code of conduct, giving sufficient grounds for dismissal if the rules are violated.

Business Policies: Operations

The central intention of business policies is to support the company's strategy. The executives in charge need to question the ultimate purpose of each function or set of actions. In order to create an effective policy, they must identify the most impactful elements in the value chain and institute the guidelines that will bring about the intended results at the lowest risk.

If customer retention is the most important factor in your revenue-generation cycle, then elaborate rules need to be established for customer service and support. If you are in an industry that depends on relationships with few big suppliers, you should have strict regulations covering that area.

Businesses with long-term contractual arrangements need to formulate code for initiation, approval, and execution of the agreements. On the other hand, companies whose success depends on constant sales effort and engagement of the customer base for generation of new transactions must have clear criteria for selling practices.

How important is the establishment of overarching, key operational policies? Harley-Davidson has been a subject of many business articles and case studies for its implementation of a just-in-time (JIT) inventory policy, which results in tremendous cost reduction but at the same time creates waiting lists in their dealerships. The entire business structure of Harley-Davidson is driven by this policy. Companies with less hard-core consumers must manufacture or acquire surplus inventories to accommodate urgent orders. Sometimes inventories are accumulated in anticipation of market changes. Whatever the reason, strict guidelines need to be established to minimize associated risks.

I believe that one of the most important sets of operational standards is the one reflecting the company's transactional philosophy. Which type of deals should you enter into and which should you avoid? Will you accept that small order that takes as long to fulfill as the larger one? If the answer impacts your company's strategy, it must be defined as a policy.

And again, as CFO or controller—and likely a member of the executive committee overseeing policy—you are in an excellent position to either make operations-related decisions or provide indispensable input.

Business Policies: Finance and Administration

I separate these guidelines from other strategy-driven policies because creating them is one of the primary responsibilities of a company's financial leader. The employee handbook and operational policies are results of collaborative efforts, significantly influenced by your CEO/owner. However, regulations governing financial and administrative areas are yours to define.

For myself, I expand the breadth of fiscal policies beyond generally accepted principles for monetary control, compliance, and reliability of standard financial reporting. (The next chapter is devoted to this part of the internal control system.) I add two more types of policies: (1) finance operational policies, and (2) what I call *bottom-line policies*.

With the variety of functions controlled by a head of finance, there are specific processes and tasks, beyond conventional accounting, that require their own regulations. Again, the subjects of these policies are dictated by the business nature and particular structure. Just as with any other business policy, examine your departments' functionality, find the pressure points, and set appropriate rules.

For example, if all your material purchases are financed by letters of credit (LCs), you should impose a policy for procurement staff to check with the finance department for facility availability before they accept any deal. On the other side of the cycle, if you accept term LCs from your customers, you may want to consider implementing a rule for discounting any instrument with a term over 90 days. This way you will not need to make an executive decision for every transaction.

The bottom-line policies are my favorite financial policies. They have to do with cost-center responsibilities, budgetary restrictions, and transactional gross margins. Working on these tricky subjects will require you to wear two hats at the same time. You have to be a flexible strategic thinker determined not to stifle the business, while trying to apply constraints to preserve your profitability and positive cash flow. It's not easy. You will find further discussion of these control methods in Chapters 10 and 11.

Theoretically speaking, administrative policies could be part of an employee handbook. However, because they are related to activities that are not necessarily applicable to all employees, I prefer to separate them. Not everyone in the company travels, hires people, or incurs out-of-pocket business expenses. The following is not an exhaustive, but definitely a representative, list of the most typical items to be covered in this section:

- Recruitment process
- Office supplies requisition
- Shipping, mailing, messaging, and courier services
- Travel approval
- Events participation
- Travel arrangements
- Corporate credit cards
- Miles utilization
- Expense reimbursements

You don't need to address every small or rarely occurring event. For example, if the only person who travels in your company is the owner, there is no need to establish any policies for him. However, all common, easy-to-generalize situations should be covered.

■ **Note** Just like laws, policies need to be ratified before they can be implemented, regardless of who develops and writes them. The complete set of guidelines must be approved and accepted by the governing body, whether that's a single person or a board.

Generally Accepted Fiscal Policies

Many risks and controls, traditionally associated with accounting functions and reliability of financial reporting, have been eradicated from our professional lives by computerized, integrated solutions. Software warns you if the entry is out of balance, it automatically prompts to the next invoice (or voucher, or check, or credit memo) number in the system, it advises if the entered account doesn't exist, and so on.

There are no more dangers of one-sided bookkeeping mistakes or posting omissions. Even the least sophisticated application knows that an invoice generated as the result of a shipped order or performed service must be recorded in the customer's account in the subsidiary "ledger" (aka accounts receivable module), and give rise to sales and accounts receivable accounts in the general "ledger" (aka general ledger module). We don't even see it happening—the system takes care of it without any human participation. This, of course, created an army of accounting clerks who are basically data processors and don't understand the nature of double-entry bookkeeping, but I will address this problem later in the book.

Together with the risks went away the necessity of creating policies and establishing monitoring tools for many standard tasks. On the other hand, we are so dependent on our computer systems today that we need a separate set of policies addressing their adequacy, setup, and security.

Still, there are several fundamental principles that permeate all fiscal activities within an organization and remain valid no matter how digitized your information processing is. These control activities are universal and must be implemented in all entities: manufacturers, traders, service providers, profit, and nonprofit. The good news is that you don't need to invent them—they have been a part of our professional foundation forever. Unlike functional policies driven by specific business characteristics, they are independent of operational variations.

In accounting canon, the principle fiscal controls are separated into loosely defined groups, but the truth is that the comprising policies, procedures, and monitoring mechanisms are so interwoven that the traditional division is somewhat irrelevant. It is the whole system that activates the controlling function.

Segregation of Duties

Frequently listed last in textbooks and digests of professional standards, this group of policies has always been my highest professional priority. Whether or not you have the time, resources, or executive support to attend to the legislative function as a whole, you must nevertheless have the guidelines for segregation of duties in place. Even if you are a one-person show, a controller, or an accounting manager with no subordinates, you must come up with a solution for implementing the safeguarding mechanisms.

The sole purpose of dividing duties is *to reduce the possibility that the same person can commit an erroneous, irregular, or illegal act, and have an opportunity to conceal it* in the normal course of his or her work. The object of the policy, therefore, is to separate the three types of responsibilities, described following, within every process that has a potential of such risk, by assigning those tasks to different people. It is important to identify the duties according to their nature so that the segregation policy works properly.

1. *Authorizing of transactions:* This isn't limited to signed or initialed requests; it could also include, for example, the marking of vouchers in the system for payment by the AP manager, or an e-mail you send to your treasury operator with the list of wires to be set up—anything that approves transactional inception.
2. *Recording of transactions:* This, with the increased sophistication of computer applications, may include not only a direct entry and posting, but also printing of shipping slips, or execution of check runs, or

any other action that prompts the system to automatically generate internal entries.

3. *Maintaining custody of assets:* This is an old-fashioned formula that evokes images of cash transactions with big safes and vaults full of stacks of paper money and rolls of gold coins; in the current age of electronic payments, a person with authority to sign a check or release a wire transfer is a custodian of the majority of your monetary assets. Other keepers of assets may include those responsible for petty cash, customers' checks, various inventories, and so on.

Of course, cash management and accounts payable functions are central concerns when it comes to segregation of duties. Ideally, CFOs and controllers should be involved only in authorizing related transactions. The most secure setups, for instance, for processing wire transfers and making check payments in a privately held company, are presented in Figure 7-1. These examples combine all the best practices: head of finance is involved only in the authorization steps, there are two people responsible for recording process at different stages, and the owner/CEO retains full custody of monetary assets.

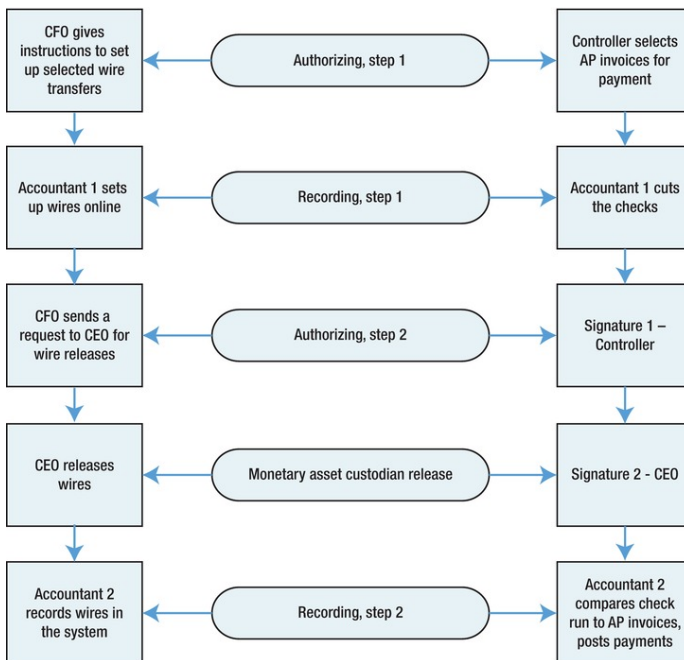


Figure 7-1. Example of segregation of duties for wire transfers and check payments

Banks' online treasury systems provide clients with multistep authorization features and dual-signature drafts, which with a proper setup should accommodate these policies. Assigning specific rights in your integrated computer system is an integral part of their implementation as well.

Hopefully, you have at least three people you can get involved in each function that calls for separation of responsibilities to minimize risks. However, in some small companies, you may not have a sufficient number of people available to comply with this requirement.

Let's say you are a controller with no supporting staff. In that case, when it comes to making payments, you have to *reduce your responsibility to recording only*. For example, pick out the invoices you need to pay, ask your CEO to approve your selection, cut the checks, pass them for his signature, and post the payments. Under no circumstances should the same person be selecting the payment, printing the check, signing, posting, and mailing it.

Not only is this a mandatory requirement of accounting management standards and ethical code—you need it for your own peace of mind. Having the segregation-of-duties policies frees you from suspicion of malice or wrongdoing if something goes wrong. There are plenty of owners out there who mismanage their businesses and run into severe operational losses—which in turn translate into cash flow shortages—and then declare that someone must have stolen the money. Protect yourself.

Making payments is not the only area with segregation-of-duties concerns. *Similar policies must be created for any situation in which the risk of cover up exists.* This may include a variety of transactions: borrowing funds, executing hedging or futures contracts, and so on. By the same token, a person in charge of releasing products from a warehouse should not be allowed to approve and post the released order in the system. Try to identify all possibilities and safeguard them by allotting tasks to different people.

Principles of Information Processing

This part of internal control deals with the general rules for data management that directly impact the integrity of financial reporting: existence of *authorization* practice as well as *completeness* and *accuracy* of transactions. Today many policies directly associated with these concepts are implemented directly through the computerization of information processing.

Authorization

While major safeguards for completeness and accuracy are usually pre-defined in integrated systems, the authorizations must be selected and set up. Study your application's potential and try to utilize as many approval features as you can.

For example, a credit manager can set up credit limits for each customer so that a new order cannot be entered if the line is full. The same can be done on your accounts payable side. A new product cannot be entered into the inventory unless a system administrator has set it up. Payroll processing will be initiated only after time cards have been marked for approval. Checks will not print unless AP vouchers are created by selecting invoices.

Even the simplest software comes with most of these capabilities. Utilizing them will assist you with implementation of transactional authorization policies.

Completeness

In the context of information processing, completeness signifies that *all transactions are recorded*. The time-proven sequential numbering of documents generated within your system is the most popular of information-processing policies. The automatic prompt to the next purchase or sales order, invoice, voucher, credit or debit memo, or check number was embedded in the earliest of accounting applications. The few remaining programs that still allow users to overwrite documents' numbers should be avoided, as they violate the very principle of minimizing risks.

Proper policy for records completeness should include rules for handling of erroneous or invalid documents with voiding checks, creating numbered credit and debit memos for sales and purchase invoices, reversing transactions in the general ledger, and so on. Your computer systems should be set up in a way that does not allow a simple deletion of entries and that requires creation of appropriate corrective entries.

As important as prenumbering is, it primarily targets transactions generated within your own system. It doesn't fully guarantee that nothing coming to you from the external connections will go amiss. Say the company's purchasing department places an order for raw materials to be delivered to the manufacturing location. When the product is received, the inventory will most likely be updated in the operational module. However, you probably have to depend on the supplier for sending you the purchase invoice.

In 2002, I went to a Microsoft conference, where they introduced the .NET Framework—a unified platform that allows developers to build applications for various devices and across the Internet, not only threading together functions within a company, but also connecting suppliers, vendors, clients, and customers into one structure. It was exhilarating to imagine the possibility of a supplier’s invoice flowing automatically into your system as soon as the product your company purchased left the supplier’s warehouse. Nothing would ever be lost in the mail or on somebody’s desk, or be stuck into the wrong folder.

Well, eventually we will get there. For now, though, the majority of small and midsize companies are still exposed to the disconnect between their own operations and the outside world. This, together with the dependency on the human factor, makes it very difficult to control the completeness of records. The combination of specifically designed procedures and monitoring tests, discussed in the next three chapters, should serve that purpose.

Accuracy

No matter how you look at it, the only true policy for accuracy is “do it right.” We constantly encourage our employees to be focused and pay attention, and ask questions if they are not sure. Still, the risk of inaccuracy exists in every single aspect of information processing. Mistakes are made with quantities, dollar values, subsidiary and control accounts selection, classification of events, and so on.

Again, a lot of responsibility for accuracy can be transferred to your software. It all depends on its capabilities. One thing I can promise you is that you are better off taking your time to study these capabilities and exhaust all possibilities for diminishing as many risks of errors as you can. The system, for example, should be able to prevent creation of a sales invoice if there is no inventory available for a particular product. You can create a fixed correlation between subsidiary accounts and control accounts in the general ledger to eliminate the necessity of selecting one from the chart of accounts when invoices are entered. Sales terms can be assigned to individual customers. Warnings can be activated for invoice amounts that don’t match order amounts. Whatever you can do, do.

Here is a typical problem. I am sure many of you have encountered the curse of duplicate customers and suppliers’ accounts, with some invoices posted there and others here. An account may have been originally set up in a last-name/first-name format. Then, an employee was looking at the list based on the first name, did not find the account, and created a new one. I have tried

to implement strict policies for account setups, specifying word order, treatment of the word *the* in corporate names, and so on. It doesn't work—it is impossible to anticipate all variations. The only way to deal with these issues is to have a policy of assigning setup rights to one conscientious person who knows to look for all variations before deciding that a new account must be created. The same goes for new products, services, employees, and so on.

One of the biggest issues of accuracy is recognition of rights and obligations. Employees responsible for related entries should have a clear understanding of the rules governing transfer of ownership based on shipping and delivery terms, which affect correctness of receivables, inventories, payables, revenues, and costs. The title passage policies are prescribed by Incoterms (International Commercial Terms), which will be further discussed in Chapter 26.

Physical Controls

These policies deal with physical security of assets, including facilities, inventories, equipment, records, and data. Generally, they fall into two categories:

1. *Authorization of access*, which should not only prevent harmful or illicit actions from outsiders, but also provide evidentiary records in case of internal misappropriation. With a variety of security systems available on the market, most companies opt to guard their premises and assets via various electronic means, including keypad locks, card readers, video monitoring, and so on. Related policies should specifically describe the accepted authorization protocol and the management of security systems.
2. *Protection from damage*, which include all your actions addressing possibilities of accidents, deliberate violations, and natural disasters. The installation of appropriate devices and measures should be aligned with the safety rules outlined in the employee handbook.

To comply with accounting rules, physical control policies should be complemented by procedures for periodic counting of material assets and comparison with existing records.

IT Security and Data Recovery

Theoretically, activities related to protection of your data are part of the physical control. However, the value of information as an asset and the

impact of its loss are so significant, the subject deserves a separate heading. I am not talking about the hardware either, which is made up of nothing more than expensive but easily replaceable generic boxes. On the other hand, the mere thought of losing years of recorded transactions, carefully designed analytical reports, performance measurements, payroll files, and so forth, makes me feel dizzy. And if your company stores customers' personal data, the importance of this issue increases exponentially.

So, forgive me for being fervent about pushing for utilization of as many options for successful data recovery as you can afford. First of all, I like the *six-disks-a-week backup policy*: Monday through Thursday, plus two on Friday. The Friday duplicate should be kept outside of the office, since the probability of some disaster happening at the same time in two places is very low. Additionally, there are Internet backup services that allow you to execute an online transfer of your fully encrypted data to an offsite center. The benefit of this option lies in the combination of storing your records away from your facilities and using the local restore functionality. If you can, have both systems in place.

Keep in mind that the centralized company-wide backup captures data that resides on your servers (file, web, mail, etc.), not on the local hard drives of individual computer stations. Not all of your employees are sufficiently computer-savvy to understand the impact of using local hard drives for storing company files. If something happens with a particular station, locally stored files will not magically appear on the backup cache. Therefore, you need a strict policy on *the use of employees' subdirectories* for all company-related files, which must be explained to all new hires during their orientation. If, for some reason, there is a need to store information on local drives, then they should be backed up separately on external hard drives, flash drives, or disks.

The necessity of a firewall as a key element of protecting your local area network from outside dangers is beyond obvious, and at this point, a simple statement that every company must have one is all that needs to be said about it. However, no firewall will provide sufficient safety if users keep inviting perpetrators to come in the door. More computer equipment and programs have been destroyed by viruses, worms, and spyware dragged in through online shopping and gaming than by physical accidents. Many employees will comply with the handbook's rule and refrain from using their stations for personal use during working hours, and then go on an Internet shopping spree instead of getting their lunch. Your *computer safety policy* should spell out the material dangers and consequences of such activities to the company's assets.

In my own experience, one of the most neglected aspects of information security is the treatment of login passwords. What frequently happens in smaller companies is that when IT administrators set up network features, mapping users' subdirectories and creating login scripts, they don't use random password generators, and instead give everyone the same generic login script: a standardized username with something like "12345" for a password. And this is viewed as all right, because the expectation is that after the initial login, every employee will create his or her own unique password. However, unless you have an explicitly expressed policy demanding everyone to do so, more than half of the people will not bother. As a result, the network becomes vulnerable to unauthorized use.

■ **Note** Accounting and finance employees have to be especially careful about the security of their login scripts, as they have access to sensitive information such as the company's financials and personnel records. They also connect to online banking and payroll services. You should be especially vigilant about systems' safety precautions when it applies to your own direct and indirect reports.

Sarbanes-Oxley Act

Widely known nowadays as SOX, this US federal law, enacted on July 30, 2002, targets publicly traded companies' accounting, internal controls, financial reporting, and board-of-directors awareness, in an effort to protect stock market investors from falling victims to the likes of Enron, Tyco, and WorldCom.

The full implementation of the law is expensive, as it requires investment in high-end accounting applications, additional personnel, and far more extensive audits. Small-cap companies have filed many complaints with the SEC, trying to get exceptions from the most expensive part of SOX, section 404—the internal control audit. This exception was finally granted in 2010. However, that's the only exclusion. So, if you work for a public company, you must abide by the law. There is a slew of readily available books devoted to elaborate interpretations and checklists that make the adoption process somewhat easier.

Privately held companies are not required to comply. Nevertheless, you should not completely ignore SOX either. There are two main reasons for any company to consider application of some of the SOX concerns. First of

all, a lot of collective effort went into study and selection of the best practices guaranteeing the reliability of financial reporting. Since SOX was paid for with the taxpayers' money, we might as well take advantage of the resulting gold standards. Secondly, *voluntary SOX compliance* can be an excellent card to play in your capital-raising efforts. Lenders, private and venture capital investors, and potential buyers will look at your company differently.

Following are some of the act's policies that I believe to be useful for any company:

- Full financial reporting disclosure, including off-balance-sheet items
- Document preservation
- Strict auditor independence by avoiding the use of a CPA firm both for audit and consulting work
- Conflict-of-interest guidelines

Having a framework of efficiently constructed accounting and fiscal policies will ease the process of formulating functional procedures discussed in the next chapter.

Procedures for Quintessential Tasks

All functional tasks must have clearly defined procedures. They are an integral part of the internal control system, which is directly responsible for the effectiveness of processes and the accuracy of information. Providing employees with these road maps is the only way to make sure that your departments carry out their responsibilities in accordance with the established policies in order to pursue the company's strategy.

You know how every time you buy a new computer, it comes with a poster-size folded brochure called "Quick Start?" It tells you what to do first, what needs to be connected and in what order, and which cables to use. The purpose here is for you to follow the steps exactly as instructed, so that you can have the new system functional and ready for use in the quickest possible time.

This, in a nutshell, is an example of an efficient procedural instruction. It's supposed to guide the user from one step to another in order to achieve the intended result. To accomplish this, a well-designed procedure document must utilize the following key elements:

- State the purpose.
- Indicate when the task is to be accomplished.
- Point out where each action must take place (this could be a physical place, a system module, a particular screen, a document file, etc.).
- Explain what documents, devices, and such need to be assembled.
- Provide the exact sequence of necessary steps to be taken.
- See if aggregate steps can be broken down further to achieve more clarity.

One of the most important things to remember while designing a procedure is that you should write for an abstract person who has never undertaken this task before. I am not talking about professional knowledge here—of course, you don't have to explain accounting terminology to your qualified employees. Yet, you have to keep in mind that the same process can be conducted differently under various policies, industrial specifics, and computer systems. Therefore, in order to create a clear and complete procedure, you must not skip any steps or meaningful details, just because you assume them to be obvious.

Another thing to remember is to make the layout user-friendly and present the sequence exactly in the way it needs to be viewed and followed. If a procedure can be related to a specific company policy, disclose the connection so that an employee will understand the task's contribution to the bigger picture.

Typical Procedure Layouts

There are two basic ways of presenting a procedure: as a process flow chart or as a narrative. I find that narratives lack the visual impact, may seem tedious, and have a tendency of being too verbose. On the other hand, sparsely worded diagrams may turn out to be too obscure. However, nothing prevents you from going beyond basics and mixing it up to achieve a better result.

I am partial to a sort of a hybrid—a flow chart with a sufficient description of each step. An example of a credit approval procedure is provided in Figure 8-1 to give you an idea of what a typical document may look like. It was created by a consulting firm, E&D CC, for a specific company. Therefore, not all the steps may apply to your operations. The arrangement presented can be easily translated into a simpler, more schematic chart, or into a descriptive manual, or an outline with sections and subsections, or a combination of any of these styles.

One important thing to remember is to be flexible. Some formats are more suitable for certain procedures, but not others. You don't have to be strictly uniform. The main purpose is clarity and comprehension.

Some companies combine a specific functional policy with a related procedure. For example, you may have a policy that customers' checks must be deposited twice a week in order to facilitate expedient account updates and improve the cash flow. The procedure for check deposits may follow after that. Alternatively, you may want to have all your policies in one place. Again, you can choose whatever methodology achieves better results.

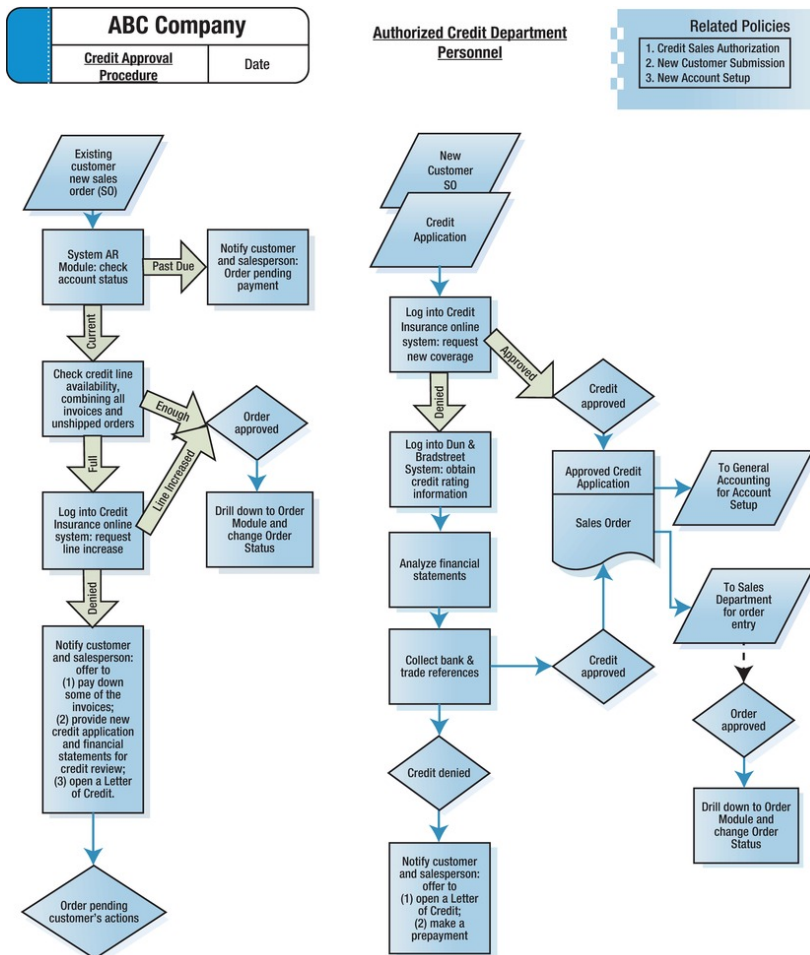


Figure 8-1. Credit approval procedure (courtesy of E&D CC)

Notable Procedures

Over the next few pages, I will highlight some of the most crucial functions, grouped by category, for which explicit procedures must be defined.

When it comes to operations of accounting and finance departments, I find the traditional *transactional cycle approach* to be the most natural way to begin assessing which procedures you need to have in place. Grouping related transactions by major functional areas provides a streamlined structure and assists in making sure that nothing is missing.

The specific cycles may vary depending on the industry and the type of entity. Service providers, for example, don't have a conversion cycle with various inventories. At the same time, some companies' financing may be very intricate and involve transactions not listed following. That said, the universal nature of accounting principles assures similarity of the core activities and procedural requirements. Most CFOs and controllers will find tasks within these generalized lists applicable to them.

Revenues and Accounts Receivable

These procedures should cover all activities related to credit, sales recording, adjustments, and collections. The word *customer* is meant here to include any recipient of your goods or services. Most companies in service industries traditionally use the word *client*. You should have procedures in each of these areas:

- New customer submissions by the sales department
- Credit line approval
- New customer account setup
- Credit sales order approval
- Credit lines increase
- Customer letters of credit (LC) acceptance
- Bank-avalized (endorsed) drafts and notes
- Customer prepayments
- Customer billing
- Royalties, licenses, franchises, and technology revenue
- Installment contracts
- Revenue recognition
- Customer returns, allowances, and discounts
- Credit sales collection

- Delinquent accounts
- Uncollectible accounts
- Receiving payments for credit sales
- Customer payments by paper checks
- Electronic check processing
- Credit card processing
- Customer sight LC presentation for payment
- Customer term LC presentation for payment
- Forfeiting
- Receiving cash payments
- Cash deposits
- Receipt posting and customer file updates

Expenditures, Accounts Payable, and Payroll

Technically speaking, the mechanics of the expenditure cycle are simple—we obtain goods or services and we pay for them. However, the vast variety and different nature of resources required for operating a business make this the broadest category of procedures.

- Material purchases, manufacturing, logistics, and other operational expenditures
 - New supplier and vendor setup
 - Supplier and vendor credit relationship management
 - LC opening
 - Prepaid purchases
 - Material purchase transaction initiation and approval
 - Vendor services acquisitions and approval
 - Royalties, licenses, and franchise fees
 - Supplier and vendor invoice identification, matching, and allocation
 - Verification and endorsement by cost centers
 - Supplier invoice coding and recording
 - Purchase returns and allowances
 - Debit memo recording
 - Accounts-payable management
 - Credit purchase payments
 - LC payments
 - Payment posting and supplier account updates

- Selling, general, and administrative expenses
 - Trade show and conference expense approval
 - Advertisement, marketing, and corporate identity program approval
 - Legal and other professional services requisitions
 - Retainer agreements
 - Insurance policies and premium payments
 - Lease management and payments
 - Services with automatic billing and periodic fees
 - Utility payments
 - Telecommunications payments
 - Postage and delivery services
 - 1099 vendors
 - Office supplies and office services requisitions and inventory
 - Corporate credit card charges verification and reconciliation
 - Employee out-of-pocket-expense reimbursements
 - Petty cash management and recording
 - Temporary employees
 - Voucher verification and approval
 - Voucher recording
 - Payment approval and recording
- HR and payroll
 - Hiring
 - New employees and HR record setup
 - Pay rate changes
 - Timekeeping management
 - Overtime
 - PTO recording
 - Bonuses and commissions
 - Employee contributions and voluntary deductions
 - Payroll processing
 - Direct deposits and payroll paper checks
 - Payroll recording
 - Payroll tax payments and recording
 - Payroll tax quarterly and annual reports
 - HR record updates
 - Labor union management
 - Labor safety procedures
 - Benefits management
 - Terminations

Inventory and Cost of Goods Sold

In manufacturing, the conversion cycle has a very literal meaning of combining various raw material inventories with labor, production costs, and fixed assets, and transforming them into a finished-goods inventory. Whether the inventory of products available for sale is manufactured or purchased in trade, upon its sale it undergoes an accounting transformation into cost of goods sold through allocation of other operational costs.

- Inventory items, cost categories, jobs, and allocations setup
- Job and production authorization
- Raw materials inventory recording, control, and valuation
- Allocation of raw material costs
- Direct labor and other manufacturing expense capitalization
- Work-in-process inventory control and valuation
- Finished-goods inventory recording
- Finished-goods inventory control and valuation
- Storage and logistics cost allocation
- Job costing
- Overhead allocation and capitalization
- Inventory/COGS conversion

Financing, Investing, and Banking

These procedures must cover all transactions related to capital, debts, investments, banking, and treasury management.

- Loan and revolving credit line utilization
- Trade finance instruments: LCs, banker's acceptances, and loans
- Borrowing base reports
- Covenants compliance
- Lender and investor reports
- Lender audits and due diligence
- Asset-based financing
- Factoring
- Leasing and equipment financing
- Commercial mortgage management
- Cash surplus investing
- Derivatives
- Financing/investment transaction recording

- Interest and fees recording
- Cash position updates
- Cash projections
- Online banking
- Wire transfers
- Check payments
- Foreign currency management and hedging
- Bank reconciliations

Fixed Assets

Traditionally, fixed assets are considered to be a part of the financing/investing cycle. However, I separated them into a special category because of the specific nature of accounting events that can be associated with their acquisition, ownership, and disposal.

- Plant and manufacturing equipment acquisition
- Computing and office equipment acquisition
- Furniture and fixtures acquisition
- Software and technology acquisition
- Property, plant, and equipment recording and expensing/depreciating
- Physical property disposal and write-offs
- Wear and tear
- Copyrights, trademarks, service marks, and other intellectual property recording and expensing/amortizing
- Research-and-development cost treatment

Month-End

Period-closing routines have a cross-functional nature, but their timing and importance warrants separating them into dedicated groups. Some functions, even though performed once a month or once a quarter, do not necessarily coincide with a period's end; others make more sense if grouped with the other procedures in the cycle—look for them in the preceding sections.

Thankfully, today all accounting systems contain features for reversible transactions, which are specifically designed in such a way that posting closing records on the period's last days triggers automatic reversal entries on the first day of the following period. This eliminates the need for creating reversing procedures.

- Accruals recognition and recording
- Expensing previous period prepaids
- Prepaids recognition and recording
- AR, AP, and merchant account reconciliations
- Depreciation and amortization recording
- Intercompany transactions recognition
- Intercompany accounts reconciliation
- Consolidation
- Internal audit tests
- Budget vs. actual analysis, monthly budget adjustments
- Period financial statements
- Key performance indicators (KPIs)
- Executive reporting packages
- Board-of-directors (BOD) reporting packages
- Sales tax reporting and payments
- VAT (value-added tax) reporting
- System modules period closing and new period setup
- Following-month budget uploads

Year-End

In addition to the regular period-end actions, there are a few transactions that are performed only at the end of the fiscal year.

- W-2 distribution and W-3 filing
- Various 1099 distributions
- System fiscal-year closing and new-year setup
- Annual financial statements, footnotes, and audit preparation
- Federal and state corporate tax returns
- General ledger chart-of-accounts adjustments
- Next-year budget setup

Documenting Procedures

I have come to regard policies and procedures as a company's intellectual property. Altogether, they contain the entity's functional know-how and constitute the framework of operative memory. It is no wonder that some employees come to feel very possessive about their way of doing things. However, as with any other asset, this knowledge does not belong to individual staff members. It is the company's property and must be treated as such.

The only way you can ensure the retention and continuity of your internal control system is through diligent documentation, systematization, and conglomeration of all relevant information. This will protect your company against the unfortunate consequences of corporate memory loss during staff movements.

Those rules, regulations, and activities that are structured and implemented by the financial executives are usually well archived in one or another format. However, unless you have been there since the founding of the company, it is most likely that there are plenty of operational methods you have adapted as practical and useful. If they are not recorded, you run the risk of losing them.

A good starting point in having them documented is to ask the person executing the task to write it out for you. It is possible you will face some resistance, which you must find a way to overcome. You may want to consider forming a *documentation committee* (or whatever you want to call it) out of those employees whose cooperation you need. Participation in something that goes beyond their daily routines may spark people's interest and make them understand their importance on a bigger scale.

■ **Note** I know only too well that the process of putting this operational manual together will take time from other urgent things you must do. The incentive to attend to this issue lays in the future benefits. If you have any doubts, just think about the time you will save by having a new hire study the well-written documents instead of personally training them and relying on their note-taking skills.

The Importance of Scheduling

A large portion of functional processes constitute daily routines; timing of others is triggered by certain events. Still, a significant number of tasks need to be performed in predefined cycles or by certain dates. Their proper timing is an important part of efficient operations. I have seen manuals developed for large enterprises and, especially, government entities that actually had the exact commencement dates embedded within procedures for all tasks.

It is hard to do the same in smaller companies. The limitations of resources and overwhelming multitasking call for a less-constricted approach. I can formulate my practical advice to fellow financial professionals in small and midsize companies in two words: *lists* and *schedules*.

Consider assisting yourself by creating the following lists:

1. Tasks assigned to each group/person, with their time frames, based on your accounting-and-finance functional structure (look back at Figure 5-4 for a quick reference).
2. Mandatory daily functions.
3. Periodic activities and reports with fixed dates, responsible parties, and intended users/recipients (weekly, monthly, quarterly, annual).
4. Long-term list with projects that are not crucial to immediate commercial goals, but are necessary to bring the company to the next level, with tentative start dates.

These lists could be the foundation of the following four schedules:

1. Current day's schedule (which I usually prepare the previous night).
2. Two-week tasks outline.
3. Two-month highlights.
4. Tentative four-month plan.

■ **Note** I would like to emphasize that *flexibility* is key: don't let yourself become obsessively rigid. Changes and diversions are to be expected and there is no reason to get worked up about them—after all, we operate in a very fast-changing business world.

The Weakest Link

Let's say you have all policies outlined and procedures carefully designed. Everything is properly documented and bound into books and manuals, which are readily available for orientation, training, and daily reference. Through an intensive internal audit program, all components have been examined; everything has been tested in practice. Whatever did not work well has been tweaked, cumbersome procedures were replaced with more straightforward ones, and the inferior ones have been improved.

Finally, it has been determined that the internal control system is both effective and efficient in accomplishing the company's goals and the executive management's objectives. Is it reasonable at this point to expect that everything should be working like that expensive watch I keep mentioning as a model of a perfect mechanism? Unfortunately not.

We don't exist in the virtual world of *The Matrix* trilogy, where everyone is manipulated by the digital code. In real life it is other way around: our well-designed systems and structures depend on being properly handled by people. Their proficiency and diligence determine how well the policies and procedures are being performed. I have mentioned the human factor dependency in Chapter 7's discussion of policies designed to increase completeness and accuracy of information processing. The truth is that every task performed by an employee is vulnerable to occasional unintentional errors, consistent sloppiness, and even deliberate mishandling.

Any designer of functional systems with frameworks that include people as key elements knows that humans are the weakest links in the chain of actions. A long time ago, when computers were so huge that a single unit occupied a

half the size of the New York Public Library's reading room, all programs and data were coded on punch cards. A punched-out spot was read by the computer's card reader as a character or a digit. These cards were *manually* created by operators trained to use a keypunch machine. Guess what? Two separate people produced every card in duplicate. No exceptions. If the cards did not match, they had to be repunched. Thus, the risk of human error was managed.

Such duplication of staff is unthinkable now. Today, we rely on computer systems to reduce at least the most common of the risks. The rest of the flaws must be caught through vigorous and persistent scrutiny of performance quality. *Monitoring is a cornerstone of internal control* and one of the most important responsibilities of a supervisor. It brings the entire system together and ensures that policies, procedures, and people concur. A series of timely and thoughtful tests should become a part of your, or your internal auditors', routine.

■ **Note** Remember, if not corrected, every mistake your employee makes will end up in financial data, documents, and reports, for which you are ultimately responsible. One erroneous entry may affect your bank's collateral statement or a presentation to the board of directors. Omissions will impair strategic decisions. Communication mishaps can impact commercial relationships. These flaws will most definitely be a poor reflection on your reputation as a financial leader. You have to create filters that will catch the debris before they pollute the results of your hard work.

The monitoring methodology varies from company to company, depending on the suitability to a particular business. The setup of your controlling system should accommodate your departmental needs. It can include standard, commonly used checks-and-balances instruments, as well as unique tools developed by you personally. Whatever the tactics, you will be pursuing three basic targets:

- *Compliance*: The procedures and policies to be followed correctly
- *Completeness*: No transactions to be missed or duplicated
- *Accuracy*: Everything to be recorded correctly

The types of techniques described in this chapter were chosen because they help in preventing mistakes that occur most frequently. It is my expectation that many CFOs and controllers in small and midsize companies will consider this selection to be a good starting point. Yet it is by no means exhaustive. If

you feel the need to look for more options, just go through your old auditing book. When it comes to technical tools, they are pretty much the same for both external and internal audits. At the same time, don't try to replicate an independent auditor's process. You have the benefit of an insider; you know your operations intimately—sometimes you can feel an error in the air. Follow your professional instincts.

Watch and Listen

In formal auditing, physical observation is usually reserved for the processes considered to be of the lowest risks. For example, accounting staff's phone etiquette is far less crucial than that of service desk representatives, who affect customer satisfaction, or of debt collectors, whose mistakes have legal ramifications. Paying attention to employee actions will not eradicate book-keeping mistakes. Nevertheless, keeping your eyes and ears open can play a positive role in preventing some problems.

Unless there is a confidential meeting or a conference call, I always keep my office door open. The accounting and finance departments usually have a very low noise level, so my workflow is not disturbed. Because employees are aware of this and can observe me working as well (which is good for their morale), they don't consider this an intrusion—eventually everyone gets used to it. I also refrain from unnecessary meddling and wasteful interferences.

Still, from time to time, there will be a need to step in. On some occasions, you will overhear your subordinates leaning toward a wrong solution for a problem they are discussing, and with a quick interjection you will be able to correct the course of action. In another instance, you may witness your credit manager on the phone with a difficult delinquent customer and decide to contribute your negotiation skills to get a payment instead of letting the situation escalate into a shouting match.

Watching staff working while you're merely passing through may alert you to some changes that require your attention. Let's say you have a new accounts-payable staff member who was trained two months ago. For a while you saw an open procedural manual next to her every time you walked through the room. Now it's gone. This could be a good time to suggest to her immediate supervisor to check that the processes are truly memorized correctly and the functions are performed in compliance with your policies and procedures.

One facet of contemporary office operations that is very difficult to control is e-mail communication generated by your employees to the company's

external relations. In the absence of a face across the desk or a human voice on the other side of the telephone line, people frequently lose their sense of propriety and self-discipline. The problem becomes especially acute when accounting and finance employees are responsible for contacts with important customers, vendors, bank officers, and so on.

Over the years, I've had several unfortunate firsthand experiences with my own subordinates. In one case, my trade finance specialist wrote to a bank's credit officer that she "should go bowling with the other blond bimbos in her group." Let me tell you, the damage control campaign I had to launch in order to prevent losing the credit line with that bank took a huge chunk of my working week. Moreover, I had to personally apologize to the offended party, plus the financial institution's executive VP, and my own boss.

My advice is to define a group of high-sensitivity correspondents and establish the rule that all electronic exchanges with them are copied to you. Don't forget to include your bosses in this category—you need to know what goes to them out of your departments. This is also useful for the particular relationship's track record. Of course, with the current Internet speed, the retraction of inappropriate e-mails is useless, but at least you will be aware that something requires your immediate attention.

Common-Sense Tests

As I already mentioned, nobody has a better feel for your numbers than you. Having a good understanding of what makes and what does not make sense in your books and records empowers you with an ability to spot errors just by looking at the figures. It is useful to develop criteria for particular information, and then you, or your capable direct reports, can eye-scan the data for the items that stick out.

Here are a few examples that should give you a general idea about the essence of this control task:

- Look through a detailed printout of the general ledger sales account. If your sales invoices normally range between \$100,000 and \$1,000,000, and you spot a \$10 or a \$10 million entry, something is incorrect.
- If you see debit entries in your sales account that are not identified with credit memo numbers, investigate those entries.
- If in the normal course of business you don't accept returns, and price adjustments require a special approval process, yet all of a

sudden you see a series of credit memos in your detailed records, it is a reason to be alarmed.

- Let's say your raw materials inventory turnover is usually 120 days. But, when reviewing the details of inventory as of the end of the month, you spot items there with nine-month-old purchase invoices. This is a good reason for a physical check of those particular lots.
- Your landlord's bill includes electricity charges that vary between \$800 and \$1,500. You established a policy that rent is separated from utilities and each is posted to its corresponding account. When reviewing the details of these accounts in the general ledger, you see a \$950 charge in the rent account and \$18,000 in the utilities account—an obvious misposting error.

As you can see, there are no special tests, no sampling, nothing sophisticated—just a good knowledge of what makes commonsense on your books.

One of the oldest error-spotting tactics used by bookkeepers in resolving unbalanced accounts or discrepant totals is the mathematical effect of transposing digits: the difference between correct and mistyped numbers is always divisible by 9. For instance, if the original number was 148 and the number entered was 418 (1 and 4 are switched), the difference is 270, which is divisible by 9. So, if the discrepancy you are investigating is divisible by 9, it is possible a result of transposed digits—one of the most common mistakes made by human beings.

Those companies who strive to integrate all their functions into one system are rarely exposed to this particular type of error. However, many smaller companies use different special-purpose programs and frequently need to reenter data from one system into another (e.g., working hours from time-clock software into the payroll system in the absence of direct upload feature). So, if the totals of the original and the transferred sets of numbers do not match, calculate the difference between the two, and if it is divisible by 9, look for transposed digits.

I ♥ T-Accounts

This long-forgotten visualization aid for depiction of general ledger accounts is my favorite tool for spotlighting possible omissions and misstatements. By analyzing T-accounts related to each other through transactional cycles, you can verify the correctness of general ledger account balances at the end of a period. It especially helps if you have proven independent data you can incorporate into the analysis. For example, a cash account reconciled with a

bank's statement provides reliable outside information for both revenue and expenditure cycle tests.

■ **Note** This is probably a good place to draw your attention to the importance of your chart-of-accounts setup. It should sufficiently accommodate your transactional details and separate different types of assets, liabilities, equities, revenues, and expenses in such a way that your trial balance provides a clear reflection of the business specifics. I am noting it here because adequately elaborate accounts and subaccounts ensure the possibility of efficient accuracy tests, particularly narrowing the field of detective work. However, we will come back to this issue again in other sections, including in the discussion of performance analytics in Part V.

In the example presented in Figure 9-1, it is assumed that “Operational Cash Account” is both a dedicated bank and a matching general ledger account used specifically for movements related to the company's commercial activities. Thus, the incoming funds exclusively represent collections of customers' accounts receivables. When the cash account is reconciled against the bank statement, you can rely on the amount debited as receipts to be accurate.

Now you can use this number to calculate what your commercial receivable balance should be. By adding total sales to the beginning balance and then subtracting returns and allowances (in this example, these two numbers are verified), as well as the bank-confirmed cash receipts, you arrive at the expected ending balance. The result does not match the general ledger control account. The obvious conclusion is that the actual amount of receipts posted during the period differs from the total of funds deposited into the bank account. The discrepancy of \$275,000 represents a customer payment (or several payments) that was misposted and credited to some other account. Now you can look for it and correct the error.

Operational Cash Account		Commercial Accounts Receivable	
BB	\$325,600	BB	\$1,567,800
	\$3,568,700	\$4,986,675	\$78,987
		Matches total of invoices	Matches total of credit memos
EB	\$165,400		\$3,568,700
	GL Acct Balance	\$2,906,788	Customers' rcpts as per Bank
	Reconciled with bank statement	\$3,181,788	Calculated AR Balance
		Discrepancy: \$275,000	AR Balance as per GL
Sales Revenues		Returns & Allowances	
	\$4,986,675		\$78,987
	GL Acct Balance		GL Acct Balance

Figure 9-1. Example of a T-accounts test for a general ledger accounts-receivable account

The T-accounts exercises are also the best double-entry bookkeeping training tools for those young staff members who are blindsided by the out-of-sight accounting software manipulations and lack the true understanding of our profession’s mechanics. You can show them that when sales are recorded, the same amount is debited to the receivable asset and credited to the revenue account; the opposite happens when credit memos are entered for returns and allowances, and so on.

Control Accounts vs. Transactional Totals

With very few exceptions, your general ledger control accounts—such as accounts receivable, accounts payable, inventory, revenue, and expenses—should be “fed” through transactions posted in correspondent subsidiary modules: customer invoices and collections, vendor invoices and disbursements, production job orders, and so on.

If you use high-end accounting software, you most likely have an option of setting up your general ledger accounts in a way that prohibits direct entries. Many companies opt to do so. If there are adjusting entries to be

made that have nothing to do with a particular customer account, for example, you need to set up a separate adjusting account, which is a good practice anyway. However, if you utilize a program without such an option, or for one or another reason choose to leave the control accounts unrestricted to direct fixing, you are opened to possibility of incomplete and inaccurate general ledger balances.

If that is the case, you must have a monitoring system that *reconciles the control accounts with transactional totals*. In the T-account example in Figure 9-1, general ledger period-ending balances of revenues account and returns-and-allowances account were matched against totals of invoices and credit memos booked during that period. In the case that these records do not concur, you would need to look for errors there.

If you don't have a practice of generating transactional-detail reports, I suggest you start doing that right away. Most accounting software nowadays comes with exporting options, which allow you to draw detailed data and then throw it into, let's say, Excel. For instance, you can create a full list of supplier invoices for a particular period within your accounts-payable module, export it into a spreadsheet, manipulate it into a convenient form, and use the result as your material purchases transactional report. Then you can reconcile it with the debit booked during the period into your general ledger raw-materials-inventory account.

Jobs or projects modules in your operating system, and even separate specialized software, can be useful resources that you can utilize in your accuracy and completeness testing. Many operational departments prepare their own managerial reports, rich with transactional details that you can employ in your quest for quality. Discuss this with your executive peers and you may find informational treasures.

Did You Lose Something?

Conceptually speaking, to assert completeness is the most difficult test. The complications originate in the mere fact that you are looking for evidence of things that potentially, but not necessarily, could be missing. The task is further hindered by the limited availability of informational resources. Even during your annual audits, you have to plead with your banks/vendors/customers/clients to reply to the confirmation letters.

Nevertheless, as limited as they are, there are ways of reducing the probability of transactions going missing:

- First of all, remember the document-numbering system discussed previously. If your accounting software allows transactions to be deleted, scan the records for sequential breaks and investigate the omissions.
- The bank statement, of course, is our greatest resource for verifying that accounts affected by cash inflows and outflows are correct.
- I cannot overemphasize the importance of issuing monthly customer/client statements. Many companies choose to establish criteria of sending statements only to delinquent accounts, but that reduces this valuable document to a one-dimensional collection tool. If you distribute the statements to all your customers, they will work for you as a quality-control instrument as well. Electronically delivered statements have been gaining popularity lately, and I think they are great not only because they are economical, but also because for the majority of people e-mails have become high-priority items. If your sales department is concerned that an important and prompt customer may be offended, design a pacifying cover letter that explains the statement distribution process as a mandatory company policy.
- The same is valid for your suppliers and vendors. If you have vendors with large transactional volumes and they don't distribute statements, have your accounts-payable staff request them and perform monthly reconciliations.
- Practically all banks and financial institutions provide their credit officers and lending staff with sophisticated internal reporting systems that generate loan balance lists, credit line utilization breakdowns, and other reconcilable documents by individual client. You can utilize your good relationship with your financing contacts to obtain these reports. Some financial organizations with sophisticated online facilities provide their corporate clients with excellent user interfaces complete with a variety of daily, monthly, and annual reports.

I am positive that if you put your mind to it, you will discover even more resources to assist you in looking for things that might be lost.

Cutoff Tests

One of the most persistent accounting errors is recording transactions in the wrong period. Most of the time these mistakes occur around the end of a month or a fiscal year, and if they remain undetected, they create weighty

impacts on financial data by overstating or understating revenues, expenses, assets, and liabilities. The sensitivity of those several days before and after the end of the period is very high, and you should pay special attention to transactions that have a potential for missing the boat.

There are multiple reasons, ranging from ignorance to negligence, why these mistakes are so frequent. An accountant lacking basic knowledge of commercial terminology sees no difference between an FOB (free-on-board) and CIF (cost, insurance, and freight) material purchase, and therefore runs the risk of posting it on the wrong date. The same misinterpretation can happen to recording of sales. This is very crucial, and we will talk more about the importance of Incoterms for manufacturing and trading industries later on, in discussion of properly prepared and audited financial statements in Chapter 26.

Another common reason is running future checks, such as rents or insurance premiums, while the next fiscal period is not opened yet in your system, or two consecutive periods are opened at the same time. This is how we end up with payments dated May 1, but posted in April. People forget and make mistakes.

I worked with a staff accountant once who could not remember that it took 24 hours for the bank to credit funds into our suppliers' accounts after I initiated requests for trade financing. He used my banker's acceptance applications as source documents. If one had a last-day-of-the-month date, my payables did not match with receivables of suppliers who got their payments on the first of the following month. The first time it happened, I had an explanation session with the employee. After the second time, I ordered a "posting date" stamp and used bright red ink to indicate the proper date before the document got into his inbox.

These types of preventative measures, including educating, training, and foolproof safeguarding, are the best things you can do to ensure proper recognition of accounting period. However, mistakes still will be made. The only way to catch them is through the old-fashioned cut-off test of sampling the most susceptible transactions and matching them with the source documents. The good news is that, again, you can use your intimate knowledge of the books. It should guide you toward most likely victims and eliminate the necessity of a massive examination.

Company Performance Reviews

These methods are cousins of the common-sense scans discussed previously. The difference is that instead of checking for unusual items among transactional details, you are searching for extraordinary deviations in the aggregate numbers that reflect results of your company's business activities during the analyzed period.

If you are in an industry that follows a particular seasonal cycle and your revenue data contradicts it, this may be an indication of some extraordinary commercial or operational events, but it also could be a result of recording mistakes. Are there significant anomalies in this month's actual key performance indicators (KPIs—more about them in Chapter 23) compared to the ones you forecasted? Are there reasonable explanations, or are they results of errors?

Comparing current business analysis results with the previous period, or the same period during last year, may lead you to the discovery of incomplete or inaccurate bookkeeping. Ratio analysis and even external information may play key roles in your assessments.

Let's say your leverage ratio has been held at 4 for years, and all of a sudden it jumped to 5 this period. There have been no losses or owner's withholdings that could have reduced your equity. Moreover, the company had profits, and you did not borrow more than you usually do. That's a signal to look at your debt components for possible errors: omitted payment to a supplier or to the bank, a misposted purchase invoice, and the like.

Budgets are traditional review resources for both external and internal auditors. Line-by-line analysis of variances between actual and budgeted amounts provides a great opportunity for spotting recording improprieties. Even if you don't do anything else, you must look at your budget as the weakest link's detector.

However, budgets are not just good sleuthing tools for debris catching. They are indispensable instruments of the bottom-line control that allows CFOs and other financial execs to implement the shift in quality of their functionality, from passive reflectors into active participants in the company's business. The importance of budgets merits a separate chapter, and will be covered next.

Budgeting as a Control Mechanism

Budgets have always been essential for any effective internal control system. Governments, nonprofits, and many for-profit organizations place budgets among most significant policy documents. Historically, as industrialization fueled the expansion of economic structures and the growth of individual entities, executive management, whether bureaucratic officials or private entrepreneurs, looked for ways to plan revenues and expenses in advance. If you think about it, the entire system of centrally planned economies employed by socialist countries was nothing more than a state-controlled multiyear budget. The origin of the word *budget* itself (from *bougette*, French for *purse*) suggests the idea of monetary control.

Those accountants who view this planning instrument strictly as a fiscal dictum, especially niche budget specialists employed by large enterprises, revere the old-fashioned, labor-intensive, rigid and highly detailed long-term format, such as the one presented in Figure 10-1. It has to be displayed with huge breaks in order to fit on one page, and it is still nearly impossible to see the details. Way before computers, these documents were prepared on actual paper spreadsheets that folded out both horizontally and vertically, just like maps.

Yet here lies the contradiction: on one hand, budgets are expected to be precise accounting reports; on the other hand, they seem to belong in the realm of future predictions. By engaging in the time-consuming exercise of attempting to foretell every aspect of business dynamics, we attempt to squash the ever-changing reality into a structure that gets outdated with every passing minute. As the collapse of command-and-control economies and quarterly surprises of public companies' performance reports teach us, these efforts are basically futile.

In today's globally sensitive economy, who can possibly guess 12 months in advance every single factor that will impact your company's revenues and costs? If you work, for example, for any company that in some ways is exposed to oil-derivative products, and is therefore affected by market oil prices, how can you budget your material purchases or revenues a year from now? And the number of companies in this particular category is tremendous: from airlines to logistics services employing truck fleets to faux stucco manufacturers using polystyrene foam to apparel manufacturers protecting their goods with plastic covers, not to mention the makers of electronics, cars, soft drinks, and so forth.

The intellectual flexibility of smaller companies, though, allows us to step away from archaic forms. We cannot afford to invest our time into something that does not facilitate progress anymore. We must be more innovative in our approaches to *planning and controlling* through budgetary tools. Instead of relying on a mechanistic, year-in, year-out attitude toward this task, you can create important and intelligent devices with real impact on the company's business. *The planning purpose can be fulfilled with an aggregate annual budget and the control can be exercised by means of a detailed monthly budget.*

The *aggregate annual budget* should translate your company's strategic business plan for the upcoming year into the road map expressed in monetary terms of revenue expectations and the cost of resources required to fulfill them with desired profitability. Both the revenues and expenses can be presented in composite categories, which are easier to plan and observe.

In the *detailed monthly budget*, however, you must sensibly break those categories down into more comprehensive elements and set targeted levels for each and every one of them. Before anything else, the *controlling functionality* of this document should determine its architecture. Thankfully, nowadays all accounting programs with budget modules are designed to accommodate the detailed monthly approach by mirroring the general ledger chart of accounts and allowing budgeted amounts to be entered for each fiscal period.

In practical terms, the two most important things to keep in perspective when working on both the annual and the monthly documents are the *level of detail or aggregation and controllability of each item within the set period of time*. What exactly are you budgeting? Theoretically, you can break down your office supplies into individual categories: pens, pencils, paper, erasers, and so on. But before you do that, you should ask yourself the following questions:

- Is this detail materially significant by itself, or should it be combined with others into a meaningful category?
- Does it have a sufficient impact on the company's bottom line to warrant attention and control measures?
- Is the item controllable and can it be managed within the set parameters?

Answering these questions will provide you with a solid idea of what your budget structures should be like. For example, if you are in the business of distressed commercial debt management and depend on volumes of collection letters to be sent out to debtors on a regular basis, then paper and envelopes will be the costs of high priority—no question about that. Alternatively, if you work for a technology company that barely produces any paper documents and strives to distribute all information electronically, paper expense will not be sufficiently significant on its own.

Figure 10-2 is an example of an annual budget plotting the most significant milestones for business performance over the 12-month period. Figure 10-3 is a suggestion for a detailed monthly budget with those items of operational costs and expenses most critical for the illustrated company highlighted to indicate that they are the ones to keep in the controlling focus.

By paying close attention to these items on a month-to-month basis, working with the responsible parties, and making sure that the actual results come as close to your planned numbers as possible, you will make an invaluable contribution to your company's bottom line. This is how you generate executive impact and transform yourself from a bean-counter into a breadwinner.

Budget control is not the only way CFOs and controllers can influence their companies' performance. The next chapter discusses other methods of active participation in profit-making.

XYZ, Inc.
Aggregate Annual Budget Template

	January		February		March		November		December		YTD	
	Budget	Var.	Budget	Var.	Budget	Var.	Budget	Var.	Budget	Var.	Budget	Actual
Physical Volume	-	-	-	-	-	-	-	-	-	-	-	-
GROSS REVENUE	-	-	-	-	-	-	-	-	-	-	-	-
COGS	-	-	-	-	-	-	-	-	-	-	-	-
Operational Overhead	-	-	-	-	-	-	-	-	-	-	-	-
GROSS PROFIT	-	-	-	-	-	-	-	-	-	-	-	-
Selling Expenses:												
Commission	-	-	-	-	-	-	-	-	-	-	-	-
Marketing & Promotions	-	-	-	-	-	-	-	-	-	-	-	-
Conventional Advertising	-	-	-	-	-	-	-	-	-	-	-	-
Internet Advertising	-	-	-	-	-	-	-	-	-	-	-	-
SEO	-	-	-	-	-	-	-	-	-	-	-	-
Networking & Travel	-	-	-	-	-	-	-	-	-	-	-	-
Selling Expenses	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Salaries:												
Officer's Salaries	-	-	-	-	-	-	-	-	-	-	-	-
Executive Salaries	-	-	-	-	-	-	-	-	-	-	-	-
Office Salaries	-	-	-	-	-	-	-	-	-	-	-	-
Full-Time Employment Expenses	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Salaries	-	-	-	-	-	-	-	-	-	-	-	-
Rents & Utilities:												
Rents	-	-	-	-	-	-	-	-	-	-	-	-
Utilities	-	-	-	-	-	-	-	-	-	-	-	-
Other Rent-Related Expenses	-	-	-	-	-	-	-	-	-	-	-	-
Rents & Utilities	-	-	-	-	-	-	-	-	-	-	-	-
Technology & Telecommunications:												
Connectivity & Web-Related Expenses	-	-	-	-	-	-	-	-	-	-	-	-
LAN & Hardware Support	-	-	-	-	-	-	-	-	-	-	-	-
Software Systems Support	-	-	-	-	-	-	-	-	-	-	-	-
Telephony	-	-	-	-	-	-	-	-	-	-	-	-
Phones	-	-	-	-	-	-	-	-	-	-	-	-
Technology & Telecommunications	-	-	-	-	-	-	-	-	-	-	-	-
Professional Fees:												
Legal Fees	-	-	-	-	-	-	-	-	-	-	-	-
Accounting Fees	-	-	-	-	-	-	-	-	-	-	-	-
Recruitment	-	-	-	-	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-	-	-
Professional Fees	-	-	-	-	-	-	-	-	-	-	-	-
Corporate Insurance	-	-	-	-	-	-	-	-	-	-	-	-
Office Expenses	-	-	-	-	-	-	-	-	-	-	-	-
Banking & Financing Expenses	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL SELLING, G & A EXPENSES	-	-	-	-	-	-	-	-	-	-	-	-
EBITDA	-	-	-	-	-	-	-	-	-	-	-	-

Figure 10-2. Aggregate annual budget for manufacturing/trading companies (courtesy of E&D CC)

YZA Company, Inc.			
Detailed Monthly Budget Template			
	December'11		
	Budget	Actual	Variance
Products Sales	-	-	-
Service Fees	-	-	-
TOTAL REVENUE	-	-	-
OPERATIONAL EXPENSES:			
Product & Services Development			
Project Managers	-	-	-
Developers	-	-	-
Full Time Employment Expenses	-	-	-
Development Tools	-	-	-
Other Operational Expenses	-	-	-
<i>Subtotal: Product Development</i>	-	-	-
Customer Service			
Managers	-	-	-
Customer Service Representatives	-	-	-
Full Time Employment Expenses	-	-	-
CSR Operating System	-	-	-
Auto-Response - Phone	-	-	-
Auto-Response - Web	-	-	-
Knowledge Database	-	-	-
<i>Subtotal: Customer Service</i>	-	-	-
Technology Support			
IT Director	-	-	-
Tech Support Staff	-	-	-
Full Time Employment Expenses	-	-	-
Web Design Support	-	-	-
Web-Hosting and Support	-	-	-
Other Tech Support Expenses	-	-	-
<i>Subtotal: Technology Support</i>	-	-	-
Marketing & Advertising			
Marketing/Advertising Management and Promotional Design	-	-	-
Conventional Media Advertising	-	-	-
Google AdWords & Other Internet Placement	-	-	-
Business Identity Products	-	-	-
Marketing Literature Printing	-	-	-
Direct Conventional Mailing Campaigns	-	-	-
Direct E-mail Campaigns	-	-	-
Auto-Dialer Telemarketing	-	-	-
<i>Subtotal: Marketing & Advertising</i>	-	-	-
TOTAL OPERATIONAL EXPENSES	-	-	-
GROSS PROFIT	-	-	-
OVERHEAD:			
Executive & Administrative Salaries			
Executive Salaries	-	-	-
Administrative Salaries	-	-	-
Full Time Employment Expenses	-	-	-
<i>Subtotal: Executive & Administrative Salaries</i>	-	-	-

<u>YZA Company, Inc.</u>			
Detailed Monthly Budget Template			
		December'11	
<u>Rents, Utilities & Related Expenses</u>			
Rents	-		-
Electricity & Heating	-		-
Other	-		-
	<i>Subtotal: Rents & Utilities</i>	-	-
<u>Telecommunications</u>			
Phones	-		-
Internet Connectivity	-		-
	<i>Subtotal: Telecommunication</i>	-	-
<u>Hardware & Software</u>			
Telephony System Lease	-		-
Office Equipment Rentals	-		-
Office Equipment Maintenance	-		-
Computing Hardware Upgrade & Maintenance	-		-
Enterprise Solution Software Lease	-		-
	<i>Subtotal: Hardware & Software</i>	-	-
<u>Professional Fees</u>			
Legal Fees	-		-
Accounting Fees	-		-
PR Services	-		-
	<i>Subtotal: Professional Fees</i>	-	-
<u>Office Expense</u>			
Office Supplies	-		-
Postage & Delivery	-		-
Dues & Subscriptions	-		-
Recruitment	-		-
Travel	-		-
Meals & Entertainment	-		-
Gifts	-		-
Other Office Expense	-		-
	<i>Subtotal: Office Expense</i>	-	-
<u>Insurance</u>			
Product Liability & Crime	-		-
Corporate Liability & Umbrella	-		-
	<i>Subtotal: Insurance</i>	-	-
<u>Financial Charges</u>			
Bank Operating Charges	-		-
Merchant Services	-		-
	<i>Subtotal: Financial Charges</i>	-	-
	TOTAL OVERHEAD	-	-
	Earnings Before Income Taxes, Depreciation & Amortization	-	-

Figure 10-3. Detailed monthly budget for technology/service companies (courtesy of E&D CC)

Controlling Commerce

Regardless of the industry, business sector, organizational mission, or economic purpose, there is a point in every entity's operational cycle when it enters the realm of commerce. Traditional manufacturers, developers of various virtual products, technology companies, service providers, trading companies, and even nonprofit organizations, at a certain point along their value chains, engage in selling their output.

This is the stage in which *revenue* is created. Accounting logically follows the common sense, demanding the conversion of products into incomes and outlays into costs to be recognized only when the ownership rights are transferred. You can create a warehouse full of great items, but, unless you exchange them for their value, they will not provide you with the means to cover the *expenses* you incurred. This is the essence and the function of commercial enterprise.

The beneficial correlation between revenues and the expenses borne in order to generate them is the basic reason for any business activities. Profitability is the ultimate measure of organizational performance. So, the positive EBITDA (earnings before income taxes, depreciation, and amortization), or, as I prefer to call it, the "bottom line," is everybody's concern.

CFOs and controllers, with their proximity to the numerical indicators of the company's health, have the benefit of the quickest knowledge of the

results of commercial activities. However, this is a reactive state that has no impact on our employers' ability to survive and prosper. We must reposition ourselves as proactive agents of profitability. That should be one of the most important responsibilities on the roster of functions you pursue.

So, what can we do? Since there are two components to profitability, we should focus our commercial guidance activities in both directions: whatever costs we can control and whatever means of influence we can affect on those who carry revenue-generating responsibilities. I find the management of *cost centers*, *transactional profitability*, and *commission structure* to be the areas where our efforts can be most consequential. Each is discussed following in turn.

Cost Center Control

The previous chapter identified the budgetary function as one of the controlling mechanisms. It provides all responsible parties with guidelines for keeping levels of expenditures within defined parameters. However, just establishing the directives is not sufficient. CFOs and controllers must focus on key cost centers to monitor their performance and suggest possible improvements.

■ **Note** Cost centers are business divisions, sectors, groups, and individual employees whose activities within the company contribute to the costs, but only indirectly add to the profits. This specific nature is what brings them under the scrutiny of financial executives. Optimization of costs vs. benefits is the foundation of the controlling principles applied to these points of expenditures.

Look back at the detailed monthly budget in Figure 10-3. The shaded areas are the ones that a CFO in this type of business would consider important and controllable. Customer service, technology support, marketing, and advertising, among others, are not just fund-intensive internal services. Frequently these departments enjoy certain independence in selection of actions, acquisition of supporting tools, and engagement of outside services. Without a proper control in place, these decisions may be made without any cost/benefit considerations.

One of the most explicit example of such a cost center is a logistics department that operates by procuring services on an outsourcing basis.

Smaller manufacturers and trading companies rarely have their own truck fleets or storage facilities. Instead they pull together external resources from a multitude of companies: public warehouses, trucking companies, marine shippers, freight forwarders, custom brokers, and so on. Choosing and combining them into an efficient supply chain is the science with the cost/benefit assessment at its core.

The first rule of controlling cost centers is the implementation of bill-approval procedures. No matter who procures or engages a service or product, their actions generate bills that must be paid by the accounting department. The accounts-payable function is under your control, and that gives you power to structure the processes in such a way that agents of expenditures approve the bills, thus taking responsibility for their decisions.

Organize the distribution of vendors' invoices, whether paper or electronic, in such a way that they end up with the cost centers before they even come to accounts payable. You may consider providing the mail sorter with a list of recurring vendors divided by cost centers, so that all bills coming from, let's say, advertising media go to the marketing department, those from shipping companies go to logistics, the ones for computer peripherals go to IT, and so on. The responsible parties should approve these bills and identify the related transactions. Only after that may they pass the bills to accounting for payment.

The second rule of controlling cost centers is imposing self-tracking mechanisms on them, so that they can monitor their expenses during the fiscal period and try to plan and adjust in a way that ensures their compliance with the budgeted level. This approach works much better than all the post factum fighting that ensues after the previous period's performance is analyzed. It is also important that the cost centers go through the process themselves. It makes it their own, reducing resistance and heightening their sense of responsibility.

If your budgets are posted in the system, which allows selective access to the data, the department heads can see how their allowance is getting used up with every posted bill and react accordingly. If you use a less sophisticated system, then have someone in your AP department create tracking spreadsheets and update the cost centers with relevant information on a weekly basis.

Making managers responsible for their departments' contribution to the organization's expenses will give you an opportunity to stimulate their drive for improving performance and *searching for new ways of achieving more cost-effective results*. To illustrate this point, I would like you to refer to Figure

10-3 one more time, particularly to the customer service section. Shifting from human voice to automatic interaction can save companies up to 70% of customer service cost—something the executive in charge may be more willing to consider if the numbers are in front of him all the time. You can help with these innovations by *employing your own business acumen* and making appropriate strategic suggestions.

Transactional Profitability Control

It is not the financial head's job to dictate sales prices and procurement rates—there are usually other senior managers responsible for that. In small companies, commonly the owners are the ultimate authority in these matters. Even more frequently, the market imposes its own supply and demand rules on the trading game. That is why the banality of “buy low, sell high” advice, so readily supplied by low-quality business consultants and independent accountants, irks me. Sometimes, circumstances work against that obvious statement.

Yet, as financial leaders, we must implement programs designed to prevent commercial practices from jeopardizing the organization's well-being. The particular circumstances of your company may dictate a variety of different tactics, but my personal experience with this specific matter has crystallized into a strong opinion that our best shot to control the overall result is at *the transactional level*.

Be prepared—your efforts will be met with great resistance, especially from the sales force. The good news is that in privately held businesses, you have an opportunity to solicit the owners' support. Convince them that your purpose is to protect their pockets and you will garner their cooperation. If you decide to embark on the crusade for healthy returns, start creating the system of transactional profitability control with the following steps.

Determine the Best Point of Control

The variety of possibilities here depends on the nature of your business. Ideally, you want to position the point of control at the inception of transactional possibility, before the deal is confirmed. In simple terms, what you must try to accomplish is preventing transactions destined to lose money from entering your operational system and using up precious resources.

If, for example, your company's business is project based, then you must *insert a project profitability assessment step* into the evaluation process, which

ultimately leads to accepting or rejecting the deal. Similar concepts are applied to operations driven by jobs, dedicated trade transactions, and so on. Here is another example. Let's say as a part of your services to customers, your company integrates its product into their systems for free, even though it is a costly process. It is advisable to account for the cost of integration while assessing the profitability potential before the customer is signed on. Otherwise, there is a possibility of not recovering the investment and losing money. This is where your prerequisite knowledge of the company's operations becomes especially valuable—it should help you to define what exactly a “transaction” is, and how and where it is initiated.

Devise Methods of Profitability Calculation

Say you win the right to express your opinion on whether a transaction is good or bad for your company in terms of the contribution to the bottom line. What will be the basis of your assessment?

We all know that the most straightforward profitability calculation is for the entity as a whole: the sum of all expenses is deducted from all revenues—that's all there is to it. However, if we decide to analyze business elements (locations, projects, units), as soon as the direct revenues and costs are dealt with, we enter the intricate world of *allocations*.

■ **Note** Transactional profitability is just one of this book's subjects affected by the concept of allocation. It will be a recurring issue—most notably in the discussion of segmental performance analysis, which includes a separate section on principles of allocation (chapter 24).

In the context of the current topic, though, I would like to set you in the logical direction with a few key points:

- The most important thing is to include *all* components of the cost. Don't forget anything—start with the revenue estimate, continue with direct costs, and move on to allocation of all indirect expenses.
- At the same time, keep in mind that this is a preliminary evaluation, not an SEC report; hence, don't be afraid to use reasonable estimates.
- Manufacturing accountants deal with allocation of indirect expenses via standard costs daily when they work on per-unit costing and

pricing. I suggest you utilize the same approach: some items can be calculated as percentages in line with your overall income statement (e.g., financing costs), others as activity-based dollar rates (e.g., warehousing costs per square foot).

Establish Profit Criteria

In my opinion, you don't really need to go beyond gross profit as long as you know how much each transaction needs to contribute to overhead, plus net profit. Because you will most likely use estimates in your calculations, allow some margin of error—there is no reason to dismiss a transaction that comes within 5 to 10% of your set criteria.

Define and Implement Control Procedure

It's not enough to devise the policy and get it accepted. Unless there is a strictly followed protocol in place that makes this process a routine, you will fail at fulfilling the underlying purpose of securing the company's bottom line. It will be up to you to define the appropriate procedure.

Ideally, your system should be set up in such a way that a transaction remains inactive unless you, or a person designated by you, approves it based on the acceptable gross profit. Most software today is loaded with features that allow setup of different status levels for jobs, projects, purchase or sales orders, customer accounts, and so on. In the absence of such abilities, you will have to establish a strict practice of having transactions be submitted for your approval before they are entered into the system.

A Few Words on Commissions

Commissions (called bonuses in some industries) are curiously contradictory—they are usually revenue-driven expenses; they don't precede the commercial activity, but follow it, and that separates them from other costs. These incentives are basically wages calculated as a percentage of one or another base. And it is the selection of the base that, unfortunately, hurts most of the companies using this type of remuneration.

Traditionally, commissions are driven by volume—sales, purchases, collections, and so on. Employing a system like that stimulates the race for big numbers—the more you sell (procure, collect), the higher your commissions are. The sales force runs down every single order without any concern for

its contribution to the company's bottom line. Of course, returns, allowances, and price discounts are all accounted for in the calculations, but most of the volume-based payees don't care whether the company loses or makes money on their deals.

Even with the transactional profitability preapproval system in place, it is impossible to predict everything, and some transactions will end up losing money for one or another reason: the freight rates, for example, may suddenly go up due to a spike in oil prices. Yet, the commissions will be paid anyway, further deteriorating the bottom line.

The only way to prevent that from happening is to switch your company to *commissions paid based on the transactional gross profit*. I will not deny the fact that it is a pain: there is a lot of work involved in all the allocation processes, and the calculations will be severely scrutinized by all interested parties. Over the years of my career, I was able to implement such systems in two companies. Both times I had a dedicated analyst assigned to the task and personally dealt with complaints from the traders. But the benefits to the businesses are undeniable—no commissions are ever paid on losing deals. Think about it.

PART

III

Deep Pockets: Your Capital Resources

From start-up to full maturity, and at every stage in between, a company needs capital to finance its activity cycle from its operational inception until the realized revenues are turned into collected funds. Furthermore, availability of money in excess of immediate needs is a primary resource for sustainable growth. The basic qualifications of a successful head of finance include comprehensive knowledge of various financing means available to different types of companies, and the ability to frame an efficient capital structure applicable to a particular organization.

Options for Capital Financing

After you strip away all the complexity of risk assessments, negotiations, due diligence, legal documents, and the rest of the brouhaha surrounding financing transactions, at their core they are no different from all other commercial transactions—barter to be more precise—with money taking a role of a commodity rather than a medium. On one side of the deal, there are the deep pockets with funds they want to gainfully exchange for something; on the other side, there are entities in need of capital, prepared to acquire it by giving something up. This money-purchasing essence is clearly reflected in the translation of financing activities into accounting events: no matter where the credit goes, you debit, even if for a split second, the most current of your assets: cash.

One of the fundamental ways of classifying financial resources is by looking at the very nature of the articles expected in return for use of money. All other specific characteristics (e.g., utilization restrictions, terms, risks, and costs) are aligned with the precise types of financing and the underlying pledges or surrenders.

From the point of view of an executive in charge of this function, financing, in its broadest sense, is the act of pooling sufficient monies from all available resources in order to keep the business going. Besides the conventional channels of soliciting investments and borrowing, there are other ways of accomplishing this daunting task. In order to provide you with a complete

picture, they are presented in this chapter as well. Even these less common instruments do not violate the general rules of basic commerce: it is always about exchanges of interests and benefits.

Equity Investments

As the name itself implies, in these types of financing, money is exchanged for the rights of ownership. Institutions and individuals part with their funds, and in return become stockholders in a business. The incentive to do so is tied to the anticipation of high returns driven by either *distribution of the company's revenues* (dividends and withholdings) in proportion to the equity share or a *gainful resell of said ownership rights* in the future (public trading, merger and acquisition transactions, etc).

The great expectations are usually associated with greater risks, which are mitigated by careful analytical scrutiny and evaluation of future returns, as well as business intelligence and the due diligence process. The simplest measurement of an investment's performance (its profitability) is *return on investment (ROI)*, usually expressed as a percentage:

$$\text{ROI} = \frac{(\text{All Gains from Investment}) - (\text{Cost of Investment})}{\text{Cost of Investment}}$$

You can only attract investors with a possibility of high ROI. If it is the same as the interest rate offered by, let's say, a bank's certificate of deposit, they are better off emptying their deep pockets there without risking a penny of the original investment.

The main principle of differentiating equity investments is based on the participation availability. If a company's stock is accessible for purchase on an open market by the general public, it is conventionally called public equity. All other kinds of business ownerships are labeled private.

■ **Note** I have personally always found these traditional designations regarding equity as semantically inexact. If you think about it, anyone who invests his personal funds into a stock, whether "public" or "private," is a private investor. Nevertheless, we will follow the generally accepted terminology.

One of the most important benefits of bringing in capital through equity investments is that the resulting inflow of funds is not restricted to a particular business need. The company is free to use them in whatever areas the board of directors and executive management team find important: R&D, acquisition of fixed assets, operational volume growth, or overhead expenses backing. The newly minted owners have a vested interest in the company's ability to cover all of its monetary requirements and normally will not impose utilization constraints.

Public Equity

Those smaller entities that have matured and settled into their optimal size rarely go this route. However, if you are a dynamic company with an exponential growth potential, an IPO (initial public offering) might be in your future. For your benefit, here are a few highlights.

Successful sale of a company's shares on one of the major stock exchanges not only brings an incredible influx of cash into the operations, but it also holds a possibility of eventually making the prepublic owners mythologically rich, as their personal wealth will now be calculated in the multiples of the dollar amount next to the ticker symbol. At the time of writing this, the price of a single share of Google's stock, for example, is \$521.

Aside from the change of ownership itself, the most important thing a company gives up in exchange for this opportunity is, naturally, privacy. The expression "going public" means the same thing regardless of its application. Whether you publicize your personality, privileged information, or the company's stock, you inevitably draw the attention of many people to yourself.

The prerequisite of being allowed to offer equity to the general public is *transparency*. Stock trading is regulated by the Securities and Exchange Commission (SEC), which requires listed companies to file numerous specific reports, most notably quarterly (10-Q) and annual (10-K) financial statements, prepared by accounting companies with big names (and astronomical fees). With the introduction of the Sarbanes-Oxley Act in 2002, the establishment of accounting boards, strict audit requirements, and personal responsibilities of C-level executives, including CFOs, have become significant factors in every public company's existence as well.

Also, your performance focus must shift from being concerned with healthy operations and logical business development to actions that improve such ratios as ROE (return on equity), P/E (price-earnings), EPS (earnings per share), and so on. The company's image and the way it's reflected in the media becomes one of the highest priorities on the executive agenda.

Keep in mind that going public is an expensive decision: even without underwriter's commissions (calculated as an agreed percentage of the total deal), between legal, accounting, listing, printing, and public relations fees, the pre-IPO stage alone may cost you over \$1 million dollars. Only some of these expenses go away after public equity process is finalized. The ongoing costs will remain at around \$250,000 a year.

Private Equity

Most small and midsize companies are privately held, and that is where the majority of us work. These companies' common stock is not available for sale to the public, and frequently the transfers and sales to third parties are restricted by special agreements in order to make sure that control of the company remains with those who hold the majority of shares.

All private equity owners can be informally divided into two groups:

- The founders (or their heirs), who create companies from ideas, frequently based on their own set of professional knowledge and skills; in most cases they hold top positions in the company and participate in its executive management.
- Backers (also called financial sponsors)—investors who use their personal and/or institutional wealth (sometimes individually, but more frequently pooled) for partial or complete acquisition of companies in need of outside capital.

Because private companies are not regulated and do not report to the SEC, equity investors are actively involved in executive management and performance monitoring. After the due diligence process ends, their funding usually comes with restructuring proposals, new business strategies, and operational-change requirements, as well as monthly reporting packages. The investors frequently visit the company themselves or send their observers and in-house consultants for managerial tune-ups.

Angel Investments and Venture Capital

Some new business ideas cannot be started on a small scale—their actualization and implementation are capital-intensive processes that require significant sums of money right from the start. Alternatively, a business might start small, but further development opens possibilities of gigantic proportions that cannot be achieved without a real investment. This is particularly true with technology companies—development of digital and Internet products

and services requires a lot of sophisticated computing equipment and many man-hours of code-writing, creative marketing programs, and exposure optimization. In other words, it's expensive.

If the idea is truly innovative, viable, and attractive in terms of high-growth potential and possibly lucrative exit strategy, and you are a part of the start-up team (based on my personal experience, an exciting place to be), write the business plan and start honing your pitching techniques—you are going after *angel investments* and/or *venture capital*.

There are few major differences between angel investors and venture capital providers that must be kept in mind when considering one or another, or both:

- Angel investors are wealthy individuals with their own entrepreneurial experience who invest their personal money, while venture capital funds are corporate entities pooling individual and institutional investors together.
- Angel investments range from \$25,000 to \$1 million, while venture capital transactions are much larger—from \$500,000 to \$10 million.
- Contrary to popular opinion, both angel and venture investments are difficult to find and obtain. However, the due diligence and legal process of entering into venture capital financing is much more rigorous and taxing than that of the angel investment.

Even though they vary in the aspects just noted, there is one thing these capital resources have in common: their cost is commensurate with the high risk associated with start-up companies. So, be prepared to give up the majority of ownership to the investors in exchange for their money.

Private Equity and Mature Businesses

Private equity funds are pooled from a variety of limited partners: individuals, pension funds, insurance companies, trusts, endowments, funds of funds, corporations, and so on. A private equity firm is a company that establishes the funds and then manages its investments by employing different strategies. It primarily targets larger small and midsize companies, usually with revenues ranging from \$100 million to \$2 billion.

Institutional private equity investing is a very developed and sophisticated industry with conglomeration of all kinds of specialized entities into a funding conveyor: private equity funds, private equity management, private equity consulting, private equity auction houses, brokerage, and even private equity exchange and secondary markets.

When it comes to investing in mature businesses, the most typical strategies pursued by these firms are *growth capital*, *leveraged buyout*, and *distressed companies* investment. Growth capital is the least dramatic of these venues. It usually results in minor ownership and doesn't cardinaly affect the balance of control. It is most frequently invited when a company undergoes major restructuring, changes its operational course, or gets on the acquisition path. One of the subforms of growth capital investments is *private investment into public equity (PIPE)*: a transaction specifically designed as offering of public stock to private equity funds.

On the other hand, a leveraged buyout (LBO) is usually a purchase of a controlling share of a company, sometimes 100%. However, only a portion of the purchase price is paid out of the investment funds, with the rest (usually 60 to 90%) covered by a credit facility arranged by the buyers. These types of strategies can be pursued only by companies with steady operating cash flows sufficient to cover the repayment of the loans' principal and interest.

Harsher economic conditions consistently give rise to the practice of distressed business investment. Struggling, near-bankruptcy companies are bought, sometimes through brokerages or at organized auctions, usually with intent to revive them with new capital and heavy managerial involvement. Many firms engaged in these activities have in-house turnaround teams. Others use full-service private equity consulting firms with their own restructuring, staffing, organizational, and operational contingents.

Whether the company is doing more-or-less fine, or is struggling to survive, the only reason for the owners to give up any part of their stock, and often control, in exchange for the investors' capital, is their inability to fund continuous operations or expansion by any other means. Even though the primary purpose is, of course, financial gains, private equity funds—whether intentionally or inadvertently, through their investments—participate firsthand in preservation and development of small and midsize businesses. Some, like Lynn Tilton of Patriarch Partners, even make it their mission. Her motto, stated on the opening page of the company's site, is “Rebuilding America: One Company at a Time, One Job at a Time.”

Founders' Investments and Company's Own Capital

Both public and private equity investors expect high returns in the future, but the targets of their risk-taking are diametrically opposite. On one end, there are entities projecting images of an overwhelming success; on the

other end, there are those lacking track record, striving to grow, and even distressed. So, who occupies the middle ground?

Scores and scores of companies have been started with the founder's own money—sometimes inherited, sometimes saved, sometimes borrowed from family and friends. Frequently, there is no initial capital at all—just a sound idea, a lot of ambition, and good common sense that allows the entrepreneur to structure the operations in such a way that he can get it going, beginning on a small scale.

If the owners are interested in sustaining the organization's growth, they don't withdraw all net income as personal compensation. This allows a portion of the returns to accumulate in retained earnings, thus building the company's own equity. This precious capital must be treated with more respect than any other type of money turning around within the entity's operations. It is an impressive testimony of success and a better performance indicator than a stock market's share prices.

There are a couple of important things every CFO and controller must remember when dealing with the company's own capital. First of all, the same ROI rule applies here as to any other investment: if the business does not provide owners with better return than a bank's interest-bearing account, there is no reason for them to fight the daily war of commercial survival, investing their own time and effort and placing already accumulated wealth in jeopardy. They can just close the business, and put the money into savings. As the matter of fact, owners' capital is supposed to generate larger returns than the riskiest publicly traded stock.

Consequently, this capital cannot be assumed cost-free. When you calculate your various profitabilities, don't forget to account for the appropriate expected rate of return as a part of financial costs.

Just recently I met an owner of a jewelry-manufacturing company, which he founded with his brother 20 years ago without any outside capital. Now they are a \$50-million-a-year international organization, still operating exclusively on their own capital. He has no liabilities other than operational payables and a nearly paid factory mortgage. Every week he gets calls from new-business execs of major New York banks—he is a very attractive target for their commercial-lending products. This brings us to debt financing.

Debt Financing

In principle, *moneylending* is the simplest transaction there is—funds are provided to you for temporary use under certain conditions, which most of the time include only two terms: (1) when the money must be returned, and (2) the amount to be paid in excess of the originally borrowed sum (aka interest). The practice of making loans dates back to ancient times, with the first known written records from Assyria and Babylonia around 2000 BC. Private citizens of the Roman Empire, who amassed impressive fortunes, systematically advanced money with profit; and the interest rates were quite moderate: 4 to 12%.

Lending was a foundation of *banking*, which was further diversified when Greeks and Romans started taking deposits and exchanging currencies. Similar activities were recorded at the same time in China and India. The origins of institutionalized banking, just as with accounting, can be traced to wealthy merchant cities of Italy—Florence, Venice, and Genoa—leading with Medici Bank, established in 1397 by Giovanni Medici. As much as contemporary banks try to expand their scopes—and through mergers enter new financial territories of investments, insurances, and whatnot—the crux of the banking industry remains the same: accepting deposits and channeling them into lending activities for profit.

Extending commercial credit, especially in the United States, is a democratic, merit-based activity. A company's creditworthiness determines its eligibility for borrowing money. The healthier the business, the better chance you have to obtain loans. *As long as you are able to show steady operational returns that can assure timely repayments, ample margins to cover interest, and sufficient value to secure the risk, you will have access to many banking products.*

Companies with sufficient borrowing power enjoy additional competitive advantages and capacity to grow. Moreover, this type of financing does not entail relinquishing ownership or control. Lenders don't demand staff changes and layoffs; they don't suggest market strategies or production cycle alterations.

Of course, in the absence of direct participation in the running of business, commercial bankers have to exercise some form of oversight over their money. This is implemented through specific conditions of credit agreements, which vary depending on the nature of debts, but generally cover four major areas:

- Restrictions on *funds utilization*.
- Assets *pledged* by the company to cover risks of default.

- Performance *covenants*, which are most frequently formulated as expectations of financial ratios (leverage in particular) and margin requirements, but may also include disclosures of material changes and other stipulations.
- Periodic *reporting* (including borrowing base reports and audited financial statements) and *field audits*.

It is difficult to apply one principle of classification to the variety of credit products offered today by financial institutions. The categories described following are set apart based on the combination of their forms, uses, and unique features.

Corporate Bonds

Even though the bond market is much larger than the stock market, small and midsize businesses do not participate in this type of public borrowing—an issuance of a \$400 million debt is considered to be a small deal in that world. Yet, for educational purposes let me offer few basic points.

Corporate bonds are long-term debt instruments issued by public and private companies. They are traded together with government and municipal bonds on major exchanges. Buying a bond is equivalent to lending money to the issuer in exchange for periodic coupon (interest) payments and repayment of the principal at maturity date.

Issuance of bonds is an expensive ordeal: the underwriter's involvement is even more intensive than during the IPO process, particularly with the preparation of a prospectus, which becomes very important to mitigate the perception of high risk. This drives up commissions: on average, investment banks charge up to four times higher rates for bond deals than for stock market issuances, making over \$10 million on a \$500 million transaction.

Commercial Credit Facilities

The banking industry is very competitive. That is why banks try to diversify and offer a broad spectrum of products. And if you are creditworthy, they need your business. The majority of large banks today prefer to offer their commercial clients relationship-based lending packages that utilize all possible solutions required to accommodate specific business needs.

Most large US banks have different departments responsible for handling businesses of different sizes: under \$100 million, \$100 to \$500 million, \$0.5

to \$2 billion, and above. From the credit assessment point of view, this division is related to the size of the lines these departments handle. A credit relationship officer, let's say at JPMorgan Chase, who deals with companies under \$500 million volume, is most likely limited to credit facilities of \$20 million per company. On the other hand, if you are looking for a \$500,000 overall line, it will not be within his scope, and you have to address your needs with a small-business specialist.

If you are seeking a facility of a significant size (anything above \$3 million), the banks' due diligence process will not be limited to a mere review of audited financial statements, standard business information, and a couple of meetings. You should be prepared for a field audit of the collateral assets, as well as exhaustive questionnaires with detailed inquiries into the company's business. Further discussion of the preapproval work and term sheet negotiations will be provided in Chapter 14.

Once approved, your credit line can be structured according to your needs and used for short-term direct borrowing, letters of credit, revolving credit lines, and so on. *Most of the line's utilization is expected to be dedicated to financing your operational cycle—from purchasing of inventories to converting accounts receivable into cash.* Only a portion of the commercial credit facility (usually no more than 5 to 10%) can be utilized to fill your nonspecific liquidity needs.

The cost structure of a credit facility depends on your creditworthiness and the type of instruments you intend to use, which are all priced differently. The rates are usually expressed as LIBOR (London Interbank Offered Rate) or Prime, plus a certain percentage above it: 1%, 1.5%, 2%, and so on. Since LIBOR is the bank's own cost of money, the additional percentage represents its revenue and depends on the level of assessed risk.

Virtually all commercial loans are *secured*. You pledge your company's assets as collateral in case of a default. Moreover, the value of the pledged assets influences your borrowing power—it forms your *borrowing base*, which is used by the banks to determine your line's availability. Qualitative and quantitative limits on assets to be included in your borrowing base frequently become the most important part of your credit agreement negotiations, which will be addressed in Chapter 14.

If the company has subsidiaries and/or related companies, their assets are frequently pledged as well. Nevertheless, banks understand very well that, when it comes to private businesses, the security of the lender lies in the hands of the owners. Hence, their personal guarantees are demanded as well.

Also called *signature loans*, unsecured loans, which are based on a promise to pay without pledging any assets as collateral, are as real as unicorns. In case of insolvency or bankruptcy, the owner of unsecured debt has a general claim against the debtor's assets, but only after all specific pledges are assigned to the holders of secured papers. It is unlikely that today any bank will extend a business credit line under such conditions.

The closest you can get to an unsecured loan in business is a 12-month credit line personally guaranteed by the business owners and their spouses. This guarantee is always recorded with the state through UCC (Unified Commercial Code) forms filings. In case of default, the bank will execute a lien on the owners' personal property.

Make sure you understand very well the structure of your credit line and what you can and cannot do with it. Never violate utilization rules laid out in the credit agreement—it may jeopardize your relationship with the bank. A good example is a revolving credit line. Many CFOs and controllers borrow against it and then keep it permanently 100% utilized. If you do so, it will be hard to convince the bank to renew it. This instrument is intended to *revolve* (i.e., it must be used gradually and periodically repaid in full). Ideally, banks like to see it at zero balance every 30 days or so.

■ **Note** Besides traditional banks, there are also financial institutions with narrower commercial banking specialization: the ones who deal primarily with commodities-trading businesses, or mining industries, for example. If you are in an international business and have a concentration within certain countries, it may be useful to check if the local banks are interested in extended a dedicated line of credit to finance transactions specifically in that country.

Asset-Based Lending

Simply speaking, any time a *specific asset* is pledged to secure a loan, the transaction is classified as asset-based lending. This implies two important features of such financing:

- The amount of the loan is determined by the value of the asset; most of the time it is at least 10 to 30% lower.
- If the loan is defaulted, the asset is taken over by the lender.

This differs from securing your credit facility with the company's overall assets, as described in the previous section, where the default may result in

lenders' liquidation of sufficient assets to cover their outstanding exposure. In case of asset-based loan default, the funder keeps all payments already made and takes possession of the asset—just like in housing foreclosures. In fact, if a company has both a regular credit line and a loan with a specific asset pledge, the latter must be excluded from the facility's security.

Informally, asset-based finance can be classified into two basic forms:

- Financing that concurs with the acquisition of assets. Building mortgages, loans paying for factory machinery, and merger fundings are typical examples. The payment made to the seller of the asset is usually composed of a smaller portion paid by the borrower with the rest of the money coming from the lender. In these cases the object of the loan utilization and its security are the same asset.
- Loans utilized for the conventional purpose of bridging the company's operating capital needs during the production-inventory-receivables-cash conversion cycle. In this case, not only paid-up fixed assets, but also specific operating assets, such as itemized inventory and receivables, can be used as a pledge. Depending on the lender's risk assessment, he may place restrictions on the management of pledged assets. Frequently, for instance, a borrower's customers are instructed to direct their payments to a specified lock-box controlled by the lender, who approves both the withdrawals by the company and the repayments of the loan.

Even though they can be accessed by any business with verifiable assets, a large portion of asset-based lending deals are related to operational expansions in mining, oil extraction, manufacturing, and construction, which involve multi-million-dollar investments in fixed assets. At the same time, even intangible assets, such as copyrights, trademarks, and patents, can be used as collateral for this type of financing. Ownership of rights to popular songs, for example, can be very lucrative through licensing. Hence, there would be no problems securing a credit line with a pledge of, let's say, the Beatles' song catalog. One of the popular examples of an asset-based loan involving an intangible asset was Midway Games' financial facility, which was secured by its Mortal Kombat franchise before Warner Brothers bought the company.

Many financial service institutions and investment banks (e.g., Goldman Sachs), and all national banking conglomerates (e.g., Citigroup, JPMorgan Chase), as well as regional banks, offer asset-based lending services. There are also smaller financing firms that specialize exclusively in this form of corporate finance. Frequently, they create leveraged packages, which pool

together private equity funds with the financing company's own bank credit facilities.

People turn to asset-based lending either because it is an acceptable practice for a specific need—like equipment purchase—or because they did not succeed in obtaining or expanding conventional financing with less-restrictive security. Asset-based loans carry much higher interest rates, which, depending on the perceived risks and difficulties of reclaiming the assets, can range from 7 to 18%. Of course, the implicit cost of this type of financing can be even higher if something goes wrong and the pledge is lost.

Trade Finance

Even though a trade finance facility is usually obtained as a part of your credit relationship with the bank, their particular applications, instruments, and methods of utilization are unique and deserve a separate discussion. Not only is this type of financing used specifically in purchases/sales of materials and products, but it is also primarily intended for international commerce (i.e., for import/export transactions).

The two basic risks associated with any trade—the timely and compliant delivery of the ordered product by the buyer and the receipt of payment by the supplier—are further exacerbated when foreign entities are involved. We live in the times of overwhelming globalization of business, yet geographical distances, legal disparities, involvement of government regulations, and so on, make international trade difficult. Suppliers usually want to get paid before or on the delivery of the product, and buyers want to make sure that they pay for what they actually purchased.

Here is where banks' trade finance operations come to the rescue. Through a variety of instruments, such as *letters of credit (LCs)*, *documentary collections*, and *banker's acceptances (BAs)*, banks serve as intermediaries between buyers and suppliers, and facilitate the process of international trade risk mitigation. Unlike asset-based finance driven by a specific asset, trade finance is driven by individual transactions.

Let me accentuate the fact that by getting involved in trade transactions, the banks do not participate in the trade itself. They don't deal with goods—only with documents. An LC is a *documented payment undertaking*—that is, if the LC's conditions are met by the supplier, as proved by presentation of documents, the bank guarantees to issue the payment.

That is why (1) LCs are very literal documents, with every line being examined by the bank, and (2) LCs are part of your credit facilities—by issuing an

LC, the bank undertakes the responsibilities to pay the supplier even if you end up not having sufficient funds. If you are a new business with no credit, but your suppliers only want to work with LCs, most likely you will have to guarantee these instruments with equivalent funds deposited into the bank's security account.

These are tedious papers, but thankfully most of the banks today have an online LC interface where you can save your templates and reuse them for new transactions. Regardless, when an LC is composed, very careful attention must be paid to the specifications of products, quantities, prices, delivery, insurance, documents requirements, and so on. Then even more attention must be paid when the documents presented for payment are matched with these specifications.

Depending on the country and the foreign bank's status, there may be some intermediary and confirming banks involved. However, the majority of LC transactions fall under the following scheme:

- The buyer issues an LC at his bank (the *issuing bank*).
- The issuing bank sends the LC to the seller.
- The seller prepares both products and documents according to the LC's specifications, and goes through all logistics steps to deliver the products to the agreed point, where the ownership transfers from the seller to the buyer.
- The seller submits all required documents to his bank (the *advising bank*).
- The advising bank sends a coded message to the issuing bank and transfers the documents for examination there.
- The issuing bank examines the documents and either notifies the buyer that they are in order or provides him with the *list of discrepancies*.
- If the buyer accepts the discrepancies or the documents are clean, the payment is made to the LC's beneficiary at the advising bank.
- The buyer either funds the payment himself or finances the payment (assuming the facility is available) by converting the LC into a loan.

If your company both buys and sells overseas, you will be dealing with both "import" and "export" LCs. This banking terminology does not necessarily signify that the product ever touches US ground. Importing into and exporting out of the US are only two possibilities. I've dealt with many transactions where the product was purchased, let's say, in Germany, and delivered directly to Turkey. Still, the LC I opened to buy the product was called "import," and the one I accepted from the Turkish buyer was called "export."

Most international trade LCs are *irrevocable* and cannot be changed without both the issuer and beneficiary's agreements. In case of a *revocable* LC, terms can be changed without the beneficiary's notification. *Sight* LCs are payable on the presentation of the compliant documents. *Term* LC payments are deferred until the specified *maturity date*; they vary from 60 to 360 days.

The set of records required to be presented by the conditions of an LC may differ depending on the nature of the product, but generally it includes the following types of documents:

- *Commercial documents*: invoices, packing lists
- *Shipping documents*: bills of lading, insurance certificates
- *Official documents*: licenses, embassy legalization, certificates of origin, inspection certificates

Standby LCs are sometimes used as guarantees of open credit you may have with your foreign supplier. They are usually opened for 360 days. No documents are presented for payment against this instrument unless the buyer is in default on his regularly due invoices. It is wise to explicitly define in the LC what constitutes the default (e.g., over 90 days past due, or something like that) to prevent frivolous misuse of the document.

In many European countries, buyers can utilize their credit lines by issuing *drafts*, which are basically promissory notes confirmed (*avalized*) by the bank. They also can be sight or term drafts. If your company sells overseas and accepts these payments, you will have to engage in the *documentary collection* process. These are less secure for seller transactions than LCs, as the product is shipped first and then the shipping documents are presented to the issuing bank in order for the draft to be executed.

BAs are basically loans financing advance payments to a particular supplier for particular goods. Like all advance payments, they provide no guarantee of delivery after the payment is received. However, specifying in the BA application the payment's beneficiary and purpose creates a legal record that may be somewhat helpful in case of *force majeure* (unforeseeable circumstances that may prevent a supplier from fulfilling the contract).

Practically all US commercial banks, not just national conglomerates, have trade finance divisions. You can dedicate whatever portion of the line you may need to payments to suppliers (bankers' acceptances) or LCs. The trading assets you generate by using these instruments—inventory and accounts receivable—will in turn increase your borrowing base, providing access to more trade finance.

Many European and Asian banks are interested in opening trade finance facilities to American companies doing business in their countries. It is worth exploring these opportunities for the sake of expanding your trading powers. At the same time, keep in mind that those banks are usually more expensive and stricter in their transactional control requirements. For example, if you finance a supplier's payment with them, they will insist on making the transfer themselves rather than depositing funds into your account, which is what most US banks do.

Even though LCs carry lower rates than BAs or regular loans, their cost is not limited to the value-based rate negotiated in your bank's credit agreement. Every single move a bank makes in the process of issuing import LCs, examining documents, making payments, accepting export LCs, and so on, has its own separate fee. In order to determine the true financing cost of these instruments, you must study your banks' fees schedule and account for everything.

Sales of Financial Interests

Many people mistake *factoring* and *forfeiting* for asset-based finance. While doing so, they confuse a purpose and a substance. Indeed, these activities have to do with specific assets, and businesses use the proceeds to finance their operations. Yet, these transactions are not borrowings secured by the assets, with only a possibility of losing its ownership in case of default. Instead, in their pure, nonrecourse form, they represent actual sales, the forgoing of your financial interest in the assets in exchange for immediate funds.

Your financial cost is the discount—the difference between the asset's value and the amount you receive. Because it is a sale, there is no repayment. And nobody controls how you use the money—you can pay any business expenses, including the overhead.

The assets in question here are different forms of accounts receivable, and one of the most important attributes of these transactions is the seller's obligation not to collect on the sold accounts.

Factoring

Factoring primarily applies to domestic accounts receivable. The whole confusion of sales vs. borrowing comes from the fact that many financial institutions specializing in these transactions do both, but call them by the same name. The best way to distinguish whether you sell your invoices or borrow

against your receivables is to look for a *recourse* clause in the contract: if it is a *nonrecourse* transaction, it is a sale and can be recorded as such; otherwise, it's borrowing. The discount rates are dictated by the creditworthiness of the customers whose invoices comprise the tranche offered for sale.

Prior to the vast consolidation of banking and diversification of financial services within the same institution that we have been experiencing for the past 15 years, there were companies specializing exclusively in factoring transactions: CIT Group, Rosenthal & Rosenthal, and so on. Now, CIT Group is a middle-market full-service financial institution, but they do factoring as well. On the other hand, many major banks, particularly Wells Fargo, as well as regional financial institutions, have factoring departments.

Forfaiting

Remember those term LCs and avalized drafts I mentioned in the "Trade Finance" section? These documentary payments received primarily by exporters are perfect candidates for forfaiting. Why would you want to hold on for a year to a document issued by a foreign bank, even if your cash flow allowed you to do so? You are better off turning it into immediate cash.

Besides their international flair, these discounting transactions differ from factoring in two major ways:

- Instead of being applied to any part of or the whole receivable asset, they are related to an individual sale transaction.
- Discounts are dictated not by the creditability of the customers, but by the credit rating of the guaranteeing bank on the international forfaiting market.

The center of global forfaiting is London, UK, with London Forfaiting Company holding a leading position for the past 20 years. However, there are many US banks that discount international LCs and drafts by export regions. For example, PNC Bank (formerly National City) has close forfaiting relationships with Turkish banks. The Internet is the best source to look for these institutions.

Curious Financing Disguised As Revenue

Since forever, radio stations, newspapers, magazines, television networks, movie productions, popular web sites (such as Facebook), and even blogs (such as the Huffington Post)—let's call them collectively *content providers*—

have been “selling” their physical and virtual space to businesses for advertisement and product-placement purposes. Traditionally, the monetary volume generated this way is considered to be revenues. However, technically speaking, this practice acts more like financing—not just because the funds’ inflow precedes the products’ output and fuels the production cycle, but more importantly, because payers take high risks on the future values they may receive in return for sometimes extraordinarily high fees.

On the opposite side, it is difficult to put your finger on the cost of this form of brand financing. Commercialization of content for the sake of attracting financial sponsors has an undeniable impact on the quality of television programming, mainstream periodicals, and all other content providers. Featuring products in a major movie production requires alterations of both the screenplay and directorial choices. *The Social Network* (2010) was an undeniable critical and box office success (\$215 million, with a \$40 million budget). Yet, many reviewers felt obligated to note more than 20 prominently placed products. Mark Zuckerberg complained that it all seemed to be about the clothes they were wearing rather than the brilliant code they were writing. We may never know how much North Face paid to put all those jackets on Jesse Eisenberg, Andrew Garfield, and the rest of the cast, but we can be sure it paid for a big chunk of the movie’s production costs.

Business Nature vs. Financial Resources

In the previous chapter, the financing function was defined as an exchange of business interests between those entities searching for outside capital in order to sustain and/or grow their operations, and those in the business of selling money. It is only natural to continue this train of thought and conclude that the availability of one or another financial resource to a particular enterprise depends on a very simple notion: *what exactly does it have to offer in exchange for money?* In other words, what is attractive about my business that will induce someone to lend my company capital or make an equity investment?

With that angle in mind, for the purpose of establishing a correlation between different businesses and capital access opportunities, I have aggregated 25 industrial sectors recognized by the North American Industry Classification System (NAICS) into seven groups:

1. Industries with significant fixed assets, such as production facilities, equipment, and heavy machinery on their balance sheets: manufacturing, agriculture, mining, oil and gas extraction, utilities, and construction

2. Companies involved in acquiring inventories of raw materials and finished products and selling them through various commercial channels to business customers and consumers (i.e., the international and domestic trading sectors: import, export, wholesale, and retail)
3. Companies who provide other industries with means of distribution through commercial channels and own warehousing facilities and transportation fleets (i.e., the logistics sector)
4. Companies involved in the creation, production, and distribution of intellectual content, including books, magazines, newspapers, and software publishing; movies and music production; broadcasting; and syndication
5. The information-processing and delivery sector, which includes all telecommunications, data processing, hosting, and Internet-related businesses
6. Companies with unique inventories of entire buildings, individual units, space, vehicles, and equipment for lease and rent—from real estate to power washers
7. All types of services—professional, financial, health, and so on

The matrix in Figure 13-1 represents a summary of correlations between these industrial groups and financing resources.

■ **Note** The exercise of matching industries with financial resources is not an exact science. Every company is unique, and its particular edge may lead to opportunities not available to others. There is no law out there that prohibits you from trying to pursue venues nobody else in your industry has ever explored. The main purpose here is to provide general guidelines based on empirical prevalence. There are no strict rules, and even if there were, there are always exceptions.

Several types of fundings are *nondiscriminatory* as far as the targeted industries are concerned, and are applicable for all seven groups. For instance, from a point of view of strict economics, the nature of a company's business should be irrelevant to investors as prospective owners. As long as the company falls under the established criteria for revenue expectations and exit strategies, and thus delivers sufficient ROI, it should qualify for the investment consideration. This is one of the main reasons why there are companies not only in every sector, but also in every industry and every segment that have been started with the *founders' own capital*.

	I	II	III	IV	V	VI	VII
	Manufacturing, Agriculture, Mining & Extraction, Utilities, Construction	Import/Export, Wholesale, Distribution, Retail	Logistics: Warehousing, Transportation	Media and Software: Publishers, Production and Broadcasting	Information: Telecom, Data Processing, Hosting	Real Estate and Other Rental & Leasing	All Services
Founders' Capital	Any company can be started and sustained with the founders' own capital						
Public	There are publicly-traded companies in all industrial sectors; the key is to build a value image and perception of high growth						
Angels	Biotechnology energy and medical devices—very early stages	Consumer products, especially eCommerce	Unlikely	Software and entertainment media	Telecom & Internet	Unlikely	Business products & services
Venture Capital – startup through exit	Energy, biotechnology, medical equipment, electronics, semiconductors, consumer products, computers	Consumer products, retail & distribution	Unlikely	Software	Telecom, networking	Unlikely	IT Services, financial services, healthcare, business products
Equity Investments	Companies with history of revenue growth, high operating margins and strong management team						
Growth Capital	Companies with steady and sufficient cash flow to service the underlying debt						
LBO	Not for small and midsize companies: predominantly large organizations						
Distressed Buyout	Consumer Products	Any Logistics	Unlikely	Companies with pledgeable assets	Companies with pledgeable assets	Yes	Business Services
Corporate Bonds	Manufacturing	Yes	Secured by pledges & guarantees	Secured by pledges & guarantees	Secured by pledges & guarantees	Secured by pledges & guarantees	Companies with pledgeable assets
Credit Lines with Borrowing Base	Yes	Yes	Yes	Some intangible assets	Yes	Yes	Secured by pledges & guarantees
Other Credit Lines	Secured by pledges & guarantees	Yes	No	Unlikely	Unlikely	No	Services with significant AR
Asset-Based Lending	With export/import exposure	International	Yes	Rare	Unlikely	No	No
Trade Finance	With domestic AR	With international sales	Yes	Unlikely	Unlikely	Unlikely	Services with significant AR
Factoring	With international sales	With international sales	No	Unlikely	No	No	Unlikely
Forfeiting	No	No	No	Yes	No	No	Unlikely
Content-Based Financing							Content-related services
Debt Financing	Companies with history of revenue growth, high operating margins and strong management team						
	Companies with steady and sufficient cash flow to service the underlying debt						
	Consumer Products	Any Logistics	Unlikely	Companies with pledgeable assets	Companies with pledgeable assets	Yes	Business Services
	Manufacturing	Yes	Secured by pledges & guarantees	Secured by pledges & guarantees	Secured by pledges & guarantees	Secured by pledges & guarantees	Companies with pledgeable assets
	Yes	Yes	Yes	Some intangible assets	Yes	Yes	Secured by pledges & guarantees
	With export/import exposure	International	No	Unlikely	Unlikely	No	Services with significant AR
	With domestic AR	With international sales	Yes	Unlikely	Unlikely	Unlikely	No
	With international sales	With international sales	No	Unlikely	No	No	Unlikely
	No	No	No	Yes	No	No	Unlikely
							Content-related services
Other							

Figure 13-1. Correlation matrix showing industrial groups vs. financing resources

The same trend can be observed on the opposite side of the investing spectrum: *there are public companies in virtually every single industry*. If they have achieved sufficiently impressive growth and are promising enough to spark the investing community and business media's interest; if they deal with products or services that are assumed to be in large demand; if they present themselves as fully transparent, and analysts predict glorious earnings per share; then they are excellent candidates for IPOs.

The following list of the ten companies that went public at the time of this chapter's writing is a pretty good illustration of the industrial diversity, even though technology, predictably, dominates:

1. *LinkedIn*: Business-related web-driven social-networking service
2. *New Mountain Capital*: Private equity firm specializing in LBO, growth capital investments, and recapitalization
3. *Yandex N.V.*: Russian information technology company
4. *The Active Network*: Community-and-recreation web-driven social-networking technology
5. *Freescale Semiconductor*: Global manufacturer of embedded processing solutions (aka computer chips)
6. *Lone Pine Resources*: Canadian oil and gas exploration and production company
7. *Spirit Airlines*: "Ultra low cost airline" based in Florida
8. *Solazyme*: Alternative energy company, specializing in production of algal fuel
9. *Fusion-io*: Designer and manufacturer of computer hardware and software memory technology
10. *Taomee Holdings*: China's leading children's entertainment and media company

Because private equity firms specializing in growth capital investments and LBOs invest in mature businesses, their decisions are to a large extent grounded in companies' short-term capabilities to start producing quick results. An organization with a solid history of revenue growth and high operating margins, whose strong management team has demonstrated impressive competence sufficient to carry out the next expansion move, will be an attractive subject to an investment company looking to acquire a minor ownership position. And as long as a company has a track record and a

proven ability to sustain steady and sufficient cash flows to service the underlying debt, an LBO will be a very likely possibility.

These calculated, practically accounting-based, funding criteria make the nature of business less relevant to potential investors. If you look at the investment strategy pages of prominent private equity firms such as, let's say, the Jordan Company, you will see that their interests lie in a wide range of industries covering practically all seven groups: aerospace, automotive parts, building and industrial products, business services, chemicals, consumer products, distribution, education, energy, financial services, health care, insurance, metals, packaging, retail, telecom, transportation, and logistics.

Even when specific industries are targeted by angels, venture capitalists, and distressed buyout specialists, this targeting is predominantly related to the perception of future potentials associated with certain products and services. The main reason why the entire investment community pounces on every company that claims to come up with, for example, a new energy solution, is because it's a buzzword.

Lenders are far more specific and rigid in their business profiling. Of course, every healthy establishment that owns rather than rents its operational and office facilities, whether it is a manufacturer of electronics or a law firm, will be able to obtain a *mortgage* with a sufficient down payment. And any company in good standing may apply for a *credit line* at a bank as long as it can provide sufficient pledges and guarantees. In fact, the size of such a credit line will be in direct correlation with the company's revenue and the strength of the guarantee, rather than with the nature of business per se.

Still, many financing resources have specific business inclinations, and their availability and utilization vary from one industrial group to another. These particular interconnections are discussed following.

Manufacturing, Mining, Utilities, and Construction Companies

This is a group with the widest spectrum of opportunities to access different sources of financing, even for the smallest enterprises. The companies comprising the group manufacture products, own rights to natural resources, produce energy, and build large structures. Many of them have a potential to generate steady growth and revenue volumes that, even with bottom-line losses, look very impressive on the presentation charts. Of the entire industrial mix, these companies have the longest value chains with multistep

processes, which can be isolated into separate targets of various financial means: they are able to finance major machinery purchases with asset-based lending tools, operational growth with minor private equity investments, trading activities with banks' trade finance instruments, and so on.

By the sheer virtue of the investment size required to start a company with production facilities, mining equipment, or construction machinery, angel investors only get involved at the idea-inception stages in very selected industries—biotechnology, energy, medical devices, and so forth. These are usually companies that have a potential to grow very big, but at the same time can be started small—with financing of R&D, or prototype building and testing.

On the other hand, venture capital firms are capable of carrying new, promising companies through all stages of the financial cycles from seed (idea generation) to start-up, ramp-up, and exit. Since the exit strategy is usually their primary concern, the concentration pattern of the investments is still dominated by the industries with the highest IPO potentials, including the three mentioned in the previous paragraph, with addition of electronics, semiconductors, consumer products, and computer manufacturers.

The prevalence of outsourcing and global competition have weakened the manufacturing sector and made it a prominent target for distressed buyout leaders, particularly in the small-to-midlevel market, with many companies ranging from \$100 to \$500 million in annual revenues. This is where investors find the highest level of turnaround success.

Growing and mature companies in this group of industries are all characterized by asset-heavy balance sheets, which make them attractive to lenders looking to back their credit lines with sufficient security. Banks and financial institutions tailor their credit facilities to accommodate multitudes of needs at every stage of these entities' business cycle, from financing their operations against a borrowing base fueled by inventories and receivables to purchases of equipment and machinery secured by asset-specific instruments. Those who buy their raw materials, parts, packaging, and equipment overseas, as well as export their products abroad, devote big portions of their credit availability to trade finance in order to provide themselves with the flow of LCs and transactional borrowing.

Finally, they can sell their domestic receivables via factoring services and term documents issued to them by foreign banks on behalf of international customers on the forfaiting market. Clearly, if you are a CFO or a controller working in one of these industries and responsible for providing your employer with sufficient means to run the business, you have an opportunity to compile most diversified financing solutions.

Trading Companies

While not as attractive to investors as enterprises in the first group, most trading companies in good financial standing enjoy access to the broadest variety of banks' lending products. Still, because goods directed toward the end-user markets enjoy a fairly steady demand, and a majority of them are manufactured abroad, those companies engaged in the trading and distribution of consumer products, including e-commerce and conventional retail, have a potential to ignite interest in both angel and venture capital.

Since the end of 2010, many analysts have predicted that private equity will be eyeing retail chains. One of the recent examples (January 2011) of such a buyout is the purchase of crafts and fabrics retailer Jo-Ann Stores by Leonard Green and Partners for \$1.6 billion.

Companies of this group are the most important utilizers of trade finance facilities provided by banks. Importers and exporters of raw materials and products are limited in their payment options and exposed to high risks unless they have access to LCs and other payment instruments, where banks take intermediary responsibilities for documentary compliance. In the absence of these resources, organizations are forced to resort to prepayment arrangements, which are perilous for importers and constrictive for exporters. The banks are usually very interested in acquiring as many international clients with trade finance needs as they can because of the lucrative revenues generated through the multiple charges associated with their services. Moreover, use of the banking instruments gives rise to inventories and receivables, which in turn increase the clients' borrowing base.

With the exception of retailers, who deal directly with consumers, all other players in this group usually have significant commercial receivables that can be used as collateral for asset-based lending, or discounted for immediate cash with factors and forfaitors.

Logistics Companies

Companies specializing in transportation and warehousing are crucial for other industrial sectors as their external partners in the value chain, especially for smaller manufacturers and traders. Long before "outsourcing" has become a household term, small and midsize producers and wholesalers who could not afford to keep their own ships, truck fleets, refrigerated containers, and warehousing facilities relied on their relationships with providers of logistics services to complete their operational cycles. This important po-

sitioning assures a high rate of longevity: there are many small and midsize entities that have been in business for over 100 years. Successful organizations frequently grow and diversify through acquisition of other companies, particularly those with complementary market shares and services. Such expansive movements usually fit well into private equity investment strategies.

Purchases of property and equipment are usually financed through mortgages and other lending instruments associated with specific assets, such as marine vessels and heavy-duty motor vehicles. Many companies in this group provide their customers with credit terms and accumulate healthy receivables that can be utilized as part of a borrowing base or sold to factors.

Content Producers and Distributors

In this group of industries, software publishing and entertainment media draw attention of both angel and venture capital investors with historically attractive average ROIs. Not every computer program, iPhone application, or video game gives birth to a future international conglomerate with a multi-billion-dollar exit perspective, but statistically speaking, the chances of such an investment turning out to be a moneymaker are much higher than that of a book publishing house.

Media companies traditionally undergo frequent mergers and acquisitions. The general population drives revenues of movie studios, TV networks, and cable channels. These companies inevitably get absorbed by huge conglomerates, such as, for example, NBCUniversal, which owns 40 brands in all types of media, including NBC News, NBC Entertainment, Telemundo, Bravo, USA Networks, A&E, Universal Pictures, Focus Pictures, Fandango, Hulu, and iVillage—to name a few.

At the same time, movie-making outside of big studios, helmed by production companies, with or without distribution deals attached, technically can be considered a small-or midsize project-based business. Their financing solutions are usually combinations of private investments and loans, with the proportion between the two changing in direct correlation with the track record of prior commercial success. Production companies with steady rosters of box-office winners have much better chances securing various fundings. Of course, the attachment of big names, especially A-list actors, works wonders in these matters.

Many industries in this group rely heavily on advertising and product placement as a means of bankrolling their production cycles. From a major network to an individual blog, the attractiveness of one or another media

company to advertisers is dictated by circulation (printed media), viewership (TV and movies), and impressions (Internet) numbers. In other words, the more eyes can be drawn to the content, the higher the advertising revenues that can be generated by, for example, a web site or a small magazine.

Here are a couple of familiar and self-explanatory examples. The *New York Times*' circulation on a weekday is about 877,000, but the Sunday issue has a readership of 1.4 million—nearly 60% higher. That is why in the latter, every other page (and sometimes even more) is an ad, plus there are special inserts, and so on. By the same token, CBS's average 30-second advertising rate is about \$122,000, but during Super Bowl XLV (February 2011) it was \$3 million. And the popularity of the most famous "blog"—the Huffington Post—first attracted a sufficient number of advertisers to warrant several rounds of private equity investments, and eventually resulted in a \$315 million acquisition by AOL on February 7, 2011.

Information

Industries of this group, even though a few decades old by now, are considered new and exciting primarily because they still display high acceleration of innovative developments—it is a continuous stream of novelties. In addition, many technologies in this sector impact consumers in one way or another, which broadens their market appeal. This widespread presence is further intensified by the unusual adaptiveness of users to modern advancements—many of us cannot even imagine our lives without smartphones or streaming media (both only 12 years old). That is why angels and venture capitalists are highly attuned to start-up ideas in this sector: anything that appears cutting-edge and unique in telecommunications, networking, and especially the Internet, has a far better chance to get a pitching opportunity for funding than any other idea. And, as you can see from the preceding IPO list, the successful ones have the potential to make investors richer.

On the other hand, these industries have a very high rate of failure and rapid aging. The searing pace of advancement leaves fallen victims behind: the already mentioned smartphones made PDAs obsolete; and don't get me started on Napster or Netscape; not to mention the accounting scandals of WorldCom. All this makes banks very cautious. Of course, small and mid-size technology companies whose founders are willing to pledge their personal savings as guarantees to finance equipment purchases will be able to strike some lending relationships with their banks, but you really need to gain some revenue momentum before tapping into significant lines of credit. I personally know several information management companies that started with their owners' personal credit cards.

Real Estate and Other Rentals

This group enjoys the most streamlined financing structures, fueled by their acquisitions and inventories of rentable assets, as well as the structured inflow of receivables. As long as your credit history is clean and there are sufficient liquid funds for a down payment, the banks will be willing to finance procurement of an apartment building (or motor vehicles, or inventories of power tools, party equipment, furniture, etc.), using the assets themselves as collateral, seizable in case of a default. At the same time, leasing and rental contracts have predictable future returns and can be utilized in borrowing base financing.

Services

The service sector has the smallest playfield of financing opportunities. There is a reason why so many service firms start out with the combination of principals' personal investments and professional expertise, and continue to survive on their own cash flow. On the other hand, most service companies, with HR as their primary cost, do not need heavy capital investments to run their businesses.

Those companies that require facilities and equipment (health care), sophisticated technology (financial and business services), or R&D (IT services) for their operations frequently turn to equity investors and asset-based lenders for funding.

Soliciting Investors and Lenders

It has been said many times before that you should look for money when you don't need it. This banal statement is, nevertheless, very true. Now, more than ever, due to tightening of credit criteria and somewhat diminished financial capacities, you must look for credit long before you need it. If you start looking when you actually need the money, it will be too late. Finding investments and engaging lenders is a laborious, and frequently disheartening, ordeal. It involves a lot of groundwork and rigid qualification mechanisms. A head of finance on the hunt for new capital resources must be very well prepared.

Even though the processes are substantially different, there are certain common aspects in methodologies of soliciting investors and lenders:

- Technically speaking, you are “selling” the company to the money-holders even when no stock shares change hands. The ability to come up with a great presentation and spin the information in the most beneficial way during the pitch to either investors or lenders is crucial. Your listeners must believe that passing on this opportunity will be the worst mistake they ever make.
- Regardless of who is in front of you, the way to get them interested is by matching your company's potentials with their expectations. For example, your high inventory turnover would be very important

for a lender's evaluation of the borrowing base. On the other hand, the fact that your product is compatible with cloud technology will definitely prick up an angel investor's ears.

- Make the prospective funders feel secure. It is not enough to paint a glorious future ahead—every statement you make must be supported with solid facts and verifiable data. Nothing will guarantee them absolute security, but lenders and investors should feel that the risks are minimized and outweighed by future returns.
- Remember the power of numbers. Cognitive scientists, who study human minds as information processors, have proven that people get far more impacted by numbers than by narrations.
- Be prepared to open your books to the harshest scrutiny.

■ **Note** One of a very few rationales for spending time and money on audited financial statements, issued with unqualified opinions by a reputable firm, is that they are prerequisite documents for any type of financing soliciting. Having them does not guarantee your getting the funds you are seeking, but not having them current and readily available shuts down the possibility of even starting a dialogue about it.

Investment Bankers

When contemplating an IPO, remember that your initial pitch should be aimed at getting an investment bank's underwriter excited about the possibility of earning substantial fees. They will tell you whether you qualify to go public or not.

Different types of financial institutions perform underwriting services:

- *Full-service investment banks*, such as Goldman Sachs, Morgan Stanley, Nomura Securities, Citigroup, JPMorgan, and UBS
- *Financial conglomerates*, such as ING Group, SunTrust, and Wells Fargo Securities, among others
- *Independent investment banks*, such as Brown Brothers Harriman and Allen & Co.

There used to be a time when \$20 million companies were commonly considered for IPOs, but lately we have observed a substantial increase in required volumes. LinkedIn, for example, exceeded \$150 million in annual

revenues before going public. Recent market events lead to the conclusion that before contacting any of the institutions just listed, a business, at the very minimum, needs to demonstrate the following:

1. A history of consistent growth—20 to 25% annually
2. An ability to sustain the same level of growth in the next five years
3. \$100 million or more in revenue
4. \$1 to \$5 million in pretax profits
5. Net tangible worth of \$4 to \$6 million
6. Market value of \$40 to \$100 million
7. Public awareness of the type of products/services the company offers
8. Industry's perception of the company as one on the leading edge
9. Ability to perform better than competitors within the industry
10. Strong outside team of IPO consultants, accountants, attorneys, and public relations specialists
11. Credibility and superb experience of top management

■ **Caution** The last item is considered to be a key element by most underwriters. Many CFOs whose efforts have laid foundations for their employers' successes have fallen victim to the pre-IPO ax just because their resumes didn't measure up.

Essentially, an entity must act like a public company for at least three years prior to the IPO to display its suitability for access to the worldwide-capital resource. The mode of transparency must commence way before you make your first contact with an investment bank's underwriter. Whatever auditing requirements, including SOX compliance, are imposed on public companies, you must adapt them way in advance. You also need to get your company's name and products/services into the public's consciousness. Ideally, you should be at such a stage of exposure that when you call an IPO consultant or an underwriter, he should be aware of your company's existence already.

Angels and Venture Capitalists

This is the hardest route of them all—looking for someone to give you money when a company is at the very early stages of its development, or recently born, or, even scarier, just conceptualized. It's not like you can fall back on years of impressive performance indicators. Just imagine the momentum of conviction, interest, and trust you must generate. The salesmanship aspect of the process needs to be cranked up to full volume.

The action plan for raising seed or start-up capital has three basic parts:

- *Writing* the best possible business plan
- *Looking* for the prospective investors
- *Pitching* the project

There are a lot of products and “templates” on the Internet, offering “fast and simple” solutions for writing a business plan. And they might be OK for entrepreneuring beginners with little financial experience. However, if you are a career financial professional involved in putting together a good business plan for a start-up company, the best choice available is *Palo Alto Software's Business Plan Pro*, especially the newest Premier Edition, which allows you to import QuickBooks data and Excel spreadsheets. It provides an excellent framework for most types of prospectuses. Of course, you have to be smart about it and skip items you find unnecessary for your particular needs, while adding unique features applicable only to your case.

It is important to remember that a business plan's main purpose is to get investors interested and to validate that you do have a promising idea and a plan for its implementation. Thus, the allowed 25 pages do not need to describe the entire thought process or every technological step. All information needs to be boiled down to the very essence of the new venture. There is a multitude of opinions on the subject of what constitutes a perfect business plan. Yet, most advisors agree on the following main elements:

- Executive summary—a snapshot overview
- A brief company description
- Description of products/services
- Industry analysis
- Competitive analysis, including SWOT (strength, weaknesses, opportunities, threats)
- Market analysis and marketing plan
- Organizational plan

- Detailed funding needs with clearly identified risk-mitigating milestones
- Five-year financial model with sensitivity and ROI analysis
- Description of exit strategies

It is not easy to find, and more importantly, to make contact with the right start-up investor. Networking connections seem to be the most successful venues—as with everything, who knows who is the key. Nevertheless, there are a few Internet resources that can serve as a good starting point. *Angelsoft*, for example, is a web-driven platform used by over 650 venture capital and angel investment groups to track their deals online, and it offers entrepreneurs an opportunity to contact participating investors. Even without creating a login, you can access information on each fund.

Business Week regularly publishes lists of the top 20 investors in each category, and an online version links you to individual profiles. There are other sources to try, such as *National Venture Capital Association* and *CB Insights*—they provide listings and rankings of both national and local firms.

Pitching skills are far more important for this type of investing than for any other. You cannot just send an unsolicited business plan. The process usually starts with a written inquiry—a one-pager that summarizes the most important points of the proposal, starting with a one-line essence of the idea. If you spark an interest, you may get lucky to be invited for a pitch—a 10- to 15-minute briefing that must deliver all relevant information to the prospective investor. This is the decisive moment. If you pass this stage, you will be asked to show a business plan.

And if you are on this path, good luck! I mean it from the bottom of my heart—our economy desperately needs new products and services provided by young, small, robust entrepreneurial companies.

Private Equity Firms

As previously noted, the private equity investment field has developed into quite a complicated industry. The investment firms' strategies vary in terms of preferred types of deals, industry specialization, stages of involvement, growth requirements, and many other aspects. But before you can even begin to research them, you need to look at your company in terms of private equity considerations. That requires a lot of very specialized knowledge.

That is why many companies looking to fund their growth or overcome financial difficulties turn to private equity consulting and brokerage firms.

These consulting groups usually have strong relationships with private equity funds and are capable of matching the right one to a particular entity. They take upon themselves to conduct the due diligence that complies with their investing clients' requirements. They can also outline possible organizational and operational changes to make a company more attractive. Sometimes, investment firms choose to retain the same consultants in the post-deal stages of reorganization.

■ **Note** The private equity consulting firms are usually paid by investors; in this case, the companies seeking funding through them carry no cost associated with their services.

There is a reverse possibility as well: CB Insights, mentioned previously, is actually a service targeted toward investors looking for growth capital deals. They collect intelligence on high-growth private companies by scouting various resources, including listings of start-up financings, government grants, venture capital deals, and media mentions. So, if your company blips on their radar, there is a chance you may get a call from interested investors.

One thing I want to reiterate is that *the due diligence associated with private equity is probably the most rigorous of all other business investigations*. Your company will be invaded and dissected well beyond your audited financial statements. They will start with the same approach I recommended for you in Chapter 5 and end with checking into the personal background of every member of the key management team.

Lenders

Virtually 100% of businesses have at least one operating account in a bank, including entities employing “cash-only” relationships with their customers—they too may need to write an occasional check or make an electronic payment for this or that.

So, no matter what your company does, it has a banking relationship. That puts you on their solicitation radar. Every bank's internal system is programmed to look for specific indicators, such as cash movement patterns and balances. Combining this information with the knowledge of your organization's nature, a full-service financial institution, sooner or later, will try to offer you various products that may fit your needs, as they perceive it. It does not guarantee that you will be approved for credit, but they will explore the opportunity.

And even if they don't initiate the dialogue, it is most likely that your first step in searching for a credit facility will be with the very bank that holds your accounts. Assuming you get approved there, you may eventually need to complement their facility with those from other financial institutions. This may further lead to merging of multiple credit facilities into a *lenders' club* (not to be confused with Lending Club, a person-to-person lending web site), which is usually governed by a common credit agreement with participating lenders sharing both risks and collaterals on a *pari passu* basis (i.e., proportional to their contribution).

When starting a conversation with lenders about your financing needs, try to complement your audited financial statements (usually they ask for the last two to five years) with as much information as you can. The more, the merrier: the company's history, future projections, and so on. But keep in mind that they will come back: first, with their standard due diligence questionnaire, and then, after the initial review by their credit committee, with further questions. These are exhaustive lists with 20 to 30 detailed inquiries that, after you provide answers to each and every one of them, will become multipage documents.

Even though extensive, lenders' due diligence and, if required, field audits are selective in their focus. Concerned with the borrower's ability to repay loans and compensate LCs, or cover defaults with sufficient assets, banks concentrate on things like the following:

- Products and markets breakdown
- Fixed assets valuations
- Procurement concentration
- Sales and purchase terms
- Sales credit policies and defaults protections (e.g., credit insurance)
- Concentration and distribution of accounts receivable
- Receivables collection processes and bad-debt history
- Inventory location and turnover

Besides the quality of the collateral assets, which impact the company's eligibility and define the structure of the borrowing base, there are certain aspects of your financial statements that are crucial for the banks' decisions. These two closely related indicators are the *net worth* (difference between all assets and all liabilities) and the *leverage ratio* (total liabilities divided by net worth). As a general rule, banks would like net worth to be substantial enough to keep the leverage ratio as low as possible. Of course, like everything else, it is negotiable and depends on your company's financial strength and your ability to present a compelling argument for a higher number.

Ideally, if the interest is there, you should be able to start pressuring your financial resource for the *term sheet* as soon as you address the first wave of their inquiries. This way you will be able to negotiate the terms and conditions in parallel with the ongoing due diligence, so that both processes can be concluded in accord. The term sheet is a brief but most critical document—even though it does not constitute the financial institution’s commitment, it outlines all the key points related to the proposed credit facility and is subsequently used as a *framework for the credit agreement documentations*.

The following are the most common components of a term sheet:

- Facility’s size
- Facility’s description (demand loans, BAs, LCs, etc.)
- Security (collateral) description
- Pricing for each instrument of the facility utilization
- Borrowing base structure (which assets are included and at what percentage rate)
- Financial covenants (net worth requirements, leverage ratio, etc.)
- Other covenants. (This is a broad category, as various banks impose different restrictions, insurance demands, and disclosure requirements—all should be carefully considered, and if possible, negotiated.)
- Periodic reporting requirements. (This is another negotiable item. Try to insist on at least 15 to 20 days after the end of the month for the Monthly Borrowing Base report, 120 days after the end of the fiscal year for the audited annual financial statements, and 45 days after the quarter-end for quarterlies, which they will want reviewed by auditors. But that’s an additional expense and you can argue for the internal statements.)
- Annual line fees (\$20 to \$40 thousand, or more)

Nurturing Financial Relationships

Everything is finalized and now you have access to the capital you so desperately needed. Is this the end of the story? No, it's not. It's like childbirth: the labor is painful, but it is just the beginning of the journey. Now you have a new permanent function in your job description: ongoing relationships with your investors and continuous lenders. You have to keep them happy and protect them from regretting their decision to invest or lend.

There are three foundation blocks mandatory for establishing a rapport between a company's financial leader and the institutions or people who entrusted their funds to him:

- Timely reporting
- Abiding by the rules (regulations, laws, policies, agreement conditions, facility provisions, etc.)
- Open-line communications

My extensive experience dealing with both private equity investors and various lenders has taught me that, when it comes to ensuring a company's financial stability, perfecting this seemingly obvious protocol is one of the most important of the CFO's responsibilities.

That said, I have to acknowledge the fact that building a bond with lenders, who have the power to discontinue their credit provisions at any time, is by far a more sensitive task than maintaining a working connection with investors-turned-stockholders. The truth is, even though it is difficult to get either public or private equity investment in place, the mechanics of post-closing upkeep are not that complicated.

■ **Note** We are not talking about the pressure on the business as a whole to perform, develop, and grow, which we addressed in previous chapters. That's a given. This is a narrower topic of a CFO's responsibilities for direct relationships with funders.

As long as the organizational progress meets the investors' expectations, there is no need for special hand-holding. Financial analysts and business media deal with the investing public, while private funds take charge of their involvement. And if the company exhausts its potential for success, good relationships will not be able to prevent devaluation.

With lenders, on the other hand, it is a completely different story—they are not tied to borrowers by stock certificates and the corporate charter. A negative assessment of a company by a credit officer may result in non-renewal and phasing-out of outstanding balances, or, even worse, acceleration of all loans. This can have devastating impact on your company's ability to survive. It is impossible to overemphasize the importance of keeping your lending connections content.

That is why this chapter is primarily dedicated to nurturing your relationships with financial entities that provide you with borrowing capacity. However, first, a few more words about investors.

Investor Relations

The term *investor relations (IR)* is primarily used to describe one of the integrated responsibilities of a public company's CFO. It includes SEC reporting filed through the Electronic Data-Gathering, Analysis, and Retrieval system (EDGAR), security regulations *compliance*, and systematic *communications*—altogether designed to maintain effective two-way contact between the company and the financial community.

However, this concept can be easily applied to a company's relationships with private investors as well. Essentially, the connection is maintained by

employing exactly the same components: financial reporting, compliance with established policies and conditions, and periodic communications.

In addition to regular financial statements, various business intelligence and performance analysis reports are customarily included in investors' *monthly information packages*, which are designed to track the investment's performance. The requirements vary, but such details as capital utilization, milestone attainment, market share dynamics, customer acquisition, and realization of volume targets are most likely to be among the data deliverables. Many private equity firms have their own analysts who dissect the information provided by the portfolio companies and generate fund-wide reports.

As was underscored before, angels, venture capitalists, and private equity firms are closely involved in the organizational management of the companies in their portfolios. They provide overall guidance on structure, policy development, business strategies, and operational tactics. Equity partners are crucial members of the investees' boards of directors. They pay frequent visits and meet regularly with executive management for progress meetings. CFOs' presentations to the board of directors are expected to provide assurance of proper fiscal control and to communicate information on all important happenings, both positive and negative.

What Makes Lenders Comfortable?

It is impossible to address every single requirement imposed by the nearly 7,000 banks out there for the various lending products they offer. Yet, it can be said that in the majority of cases, when we manage a bank's credit facility, the *reporting*, *compliance*, and *communication* fundamentals acquire certain properties specific to this form of financing. These unique attributes are discussed following.

Credit Lines with Monthly Reporting

There is nothing special about the quarterly and annual financial statements you are required to submit to your bank in accordance with the schedule laid out in the credit agreement. These are the same standard audited accounting reports you prepare for multiple uses. And if your borrowing is limited to a straightforward term loan for a specific amount with a specific payment schedule, or a revolving credit line, the financial statements might be your only reporting requirement.

However, if you operate within a diversified credit facility, which is driven (entirely or partially) by the *bank borrowing base (BBB)*, you are required to

file a *monthly BBB report* (frequently called a *certificate*), complemented by supporting schedules detailing every line. If you fail to do so, your borrowing availability will be set to zero.

■ **Note** The BBB is essentially a formula that determines your company’s current borrowing capacity. It is defined in the credit agreement and consists of collateral assets included into the calculations at various percentage rates established during the term sheet negotiations.

Figure 15-1 shows a simple BBB report that is typical for many credit lines and adaptable to practically any straightforward terms. The example in Figure 15-2 is a more complex, multilevel document I have specifically created for a business with a combination of financing provided by a domestic three-bank credit club and several foreign transactional-based lines.

Company XYZ		
Bank ABC Borrowing Base Certificate		
	As of	31-Dec-XX
Total Accounts Receivable		2,864,366.54
Less: AR not backed by LCs or other bank document and over 30 days past due		(634,688.76)
Eligible Accounts Receivable		2,229,677.78
	Advance Rate	85%
(1) Collateral Value of Accounts Receivable		1,895,226.11
Documentary LCs		674,695.94
	Advance Rate	85%
(2) Collateral Value of Documentary LCs		573,491.55
Inventory on Hand (Domestic only)		286,389.37
	Advance Rate	85%
(3) Collateral Value of Inventory		243,430.96
(4) Cash at the Bank (100%)		366,961.00
Total Collateral (1+2+3+4)		3,079,109.63
Outstanding Credit Utilization		
Loans		250,000.00
Banker’s Acceptances		967,735.80
Documentary LCs		674,695.94
Total Outstandings		1,892,431.74
Excess (Shortfall)		1,186,677.89
Certification Date		
I hereby represent and warrant that the above information is correct and valid as of the reporting date.		
By: CFO’s (Controller’s) Signature		

Figure 15-1. Simple borrowing base certificate

The upside of having a more detailed formula and BBB is the flexibility of the collateral utilization you can achieve by including items that otherwise might have been disallowed altogether. In this example, such items are the inter-company receivables derived from sales to the company’s subsidiary, which are included at a 50% rate, and in-transit inventory destined for customers with cash-against-documents sales terms. The downside is the extent of work it requires to analyze the supporting data by the multiple categories of the collateral.

XYZ, Inc.			
Unified Bank Borrowing Base Certificate		<i>Prepared for Credit Club of Banks A, B & C</i>	
		MONTH ENDING:	[]
Collateral	1a Domestic AR less than 30 days past due	[]	
	1b Domestic & Int'l AR covered by LCs or credit insurance less than 90 days past due	[]	
	1c Domestic & Int'l AR - cash against documents	[]	
	2 Eligible Accounts Receivable (Line 1a + Line 1b + Line 1c)		-
	3 Accounts receivable inclusion (Line 2 * 85%)		-
	4 Inter-company AR less than 30 days past due	[]	
	5 Inter-company AR inclusion (lesser of \$500,000 or Line 4 * 50%)		-
	6a Domestic inventory	[]	
	6b In-transit inventory covered by customers' LCs	[]	
	6c In-transit inventory to customer covered by credit insurance	[]	
	6d In-transit inventory to customers cash against documents	[]	
	7 Eligible inventory (Line 6a + Line 6b + Line 6c + Line 6d)		-
	8 Inventory inclusion (Line 7 * 85%)		-
	9 Documentary LCs outstanding with the credit club banks		-
10 LCs add-back (Line 9 * 85%)		-	
11 Cash on deposit in the credit club banks		-	
12 Total collateral base (Line 3 + Line 5 + Line 8 + Line 10 + Line 11)		-	
Utilization	13 Direct Borrowings outstanding at month end	[]	
	14 Bankers Acceptances outstanding at month end	[]	
	15 LCs outstanding at month end	[]	
	16 Transactions financed by banks outside of the credit club	[]	
	17 Total financing outstandings at month end (Line 13 + Line 14 + Line 15 + Line 16)		-
	18 Excess collateral coverage (Line 12 - Line 17)		-
ATTACHMENTS:	Accounts receivable agings as of month end above		<u>e-mailed</u>
	Warehouse and in-transit inventory reports as of month end above		<u>e-mailed</u>
	Transactions financed by banks outside of the credit club		<u>e-mailed</u>
CERTIFICATION:	The undersigned hereby certifies, represents and warrants to credit club banks the following:		
	1. The description of Eligible Accounts and Eligible Inventory and the values assigned thereto are true and accurate.		
	2. All of the representations and warranties contained in the Agreement or in any loan document are true and correct.		
	3. The Borrower is in compliance with all existing loan covenants.		
	4. No event has occurred, or would result from advances made in connection herewith, that constitutes an event of default under the Agreement.		
5. The Borrower will supply additional reports and financial information as reasonably requested.			
BY: CFO's (Controller's Signature) _____		DATE: _____	

Figure 15-2. Example of a borrowing base certificate defined by a multiasset formula

Whether you do this work all by yourself or delegate the prep to your subordinates, check if the document you are about to sign makes sense. You don't want to give your bankers a chance to catch you on mistakes in your own numbers. Of course, information that can be verified by the banks'

internal systems, such as cash balances and outstanding credit items issued by them, must be confirmed first and foremost. But that's not all—the BBB has to be consistent with your balance sheet. For instance, the sum of collateral excess and items excluded from BBB can be supported only by three sources: the company's own capital, accounts payable, and financing instruments provided by other sources (which you most likely must disclose). Make sure that there are no unexplainable holes. It is especially sensitive during the quarter-ends, when you actually have to present the lender with your financial statements as well.

Covenants and Utilization Compliance

The previous chapter discussed the multitude of conditions banks impose on the borrowers through credit agreements. They vary from one financing deal to another. Most of them are cumbersome, but not too difficult to manage. Even if the lenders demand that all sales above a certain amount must be approved by them, well, it's annoying, but it's just a matter of one phone call, and you should be able to argue that this deal is a must for the survival of the company. However, the burden of *financial covenants* has a potential of influencing how business is conducted in your company, and therefore commands your careful attention.

The frequent *minimum net worth* requirement is usually implanted into the agreement in order to preclude owners from frivolous withdrawals of net profits. Banks prefer the retained earnings to remain in the company, as it reassures the going concern. But the equity is reduced by operational losses too, and you have to be very careful (within the limits of your power, of course) about not falling below the acceptable level.

The healthy net worth also helps to contain the most volatile covenant of them all—the *leverage ratio* defined in the previous chapter—as well. I've always wondered about the banks' counterintuitive insistence on limiting their clients' borrowing powers by demanding that the balance sheet liabilities be a certain multiple of the company's capital. At the end of the year, you may have millions of dollars in credit availability, but you will be hesitant to use it, because it may tip your December 31 leverage over the threshold. And that's a shame, because at the end of the year, suppliers are trying to turn their inventories into revenues—the procurement and operations are demanding from you the transactional approvals, and you are mad at your bankers for inadvertently affecting commercial activities.

What you need is an *end-of-the-period action plan*. It has to be thought out well in advance and coordinated with your executive peers. And it cannot be a moratorium on all activities—you are a member of the strategic team, not

just a financial guardian. There are many ways of easing up the liability burden on the books. They depend on the particular nature of the business, but the following general ideas may point you in the right direction of thinking:

- The collection efforts must be intensified ahead of time so that you can have more cash available either to pay down some debts or use it for advance payments.
- Suppliers normally demanding prepayments will be more motivated at the end of the year and flexible to accept LCs instead.
- Large suppliers are frequently more concerned with booking orders than recognizing revenues before the cutoff date—have them bill you on delivered terms or ship the product on January 1.

All companies are different, and it is very likely that many CFOs and controllers are never exposed to the dangers of covenants violations. But if you always walk on the razor's edge due to the company's expansion path or the industry's cyclicity, you must have a prevention program for every reporting period. Because every time you are officially incompliant, a special waiver needs to be issued by the bank. It is recorded and constitutes a red flag. If you accumulate enough of them, it can potentially impair your ability to renew the credit facility.

Paradoxically, on one hand they limit you with leverage, and on the other hand, if the facility is significantly underutilized, the bankers become unhappy, as they feel that they gave you too much credit. You must exercise a fine art of optimization to keep these matters in balance. And I cannot over-emphasize the importance of the *proper use of lending instruments*. Don't exhaust the revolving credit line and keep the balance at the maximum for months. As mentioned before, it has to be paid down completely once in a while. And never use lines intended exclusively for transactional financing to cover your overhead shortages—that for sure will get you in trouble.

Love Thy Banker

I know that many of my readers think that there is no need to schmooze bankers who have already come on board with their financial offerings. Moreover, many of us get annoyed when bankers call us just to “check how things are.” Some bankers go further, and even though you are their primary contact, they periodically attempt to call your CEO to see how things are going.

There is no reason to get irritated. An account executive in any industry, including banking, is a combination of a salesperson, an underwriter, and a client service representative. It is not like he has nothing else to do; it's an

essential part of his job to periodically check on the companies in his caseload. He entered this phone call into his calendar a few months ago and now he attends to his duties. So, be conscious of his importance for your business—chat for 10 to 15 minutes; tell him how wonderful everything is in the company. Hopefully you noted the names of his wife, children, and grandchildren—ask about them. If he wants to visit—be receptive to the idea. Lunch—even better. Trust me, it will pay off down the line.

Credit Line Renewal

Time runs fast, and before you know it a facility's *renewal* date is upon you. If it is the first anniversary, the best approach for preparation I can recommend is getting ready early. Don't wait for your bank officer to come at you with his numerous requests—he operates on his own schedule and doesn't have to be considerate about your time constraints. Maybe a couple of months in advance, get out the initial due diligence questionnaire and give it an analysis from the outsider's point of view: which items never change and which could be perceived as dynamic?

For example, let's say a part of the original exploration was the list of all manufacturing and warehousing facilities the company owns, which you provided. At the same time, according to the agreement, the lender's consent is required for divesting of any asset with a value of, let's say, \$250,000. This means that there is no reason for the bank to ask you for the list of facilities again. On the other hand, if there were requests for breakdowns of sales by countries, products, and/or markets; for top-ten listings of suppliers and customers; or for other items that may change their values from year to year; you can be 100% sure you will need to provide the answers again. So, it is better to prepare in advance. Also, refer to the agreement for the field audit requirements—some banks make annual (sometimes biannual) examination of collateral assets mandatory.

Next time around it will be easier, as you will have the firsthand experience of the previous year. That is, assuming there is no need for substantial changes in the nature or size of the facility or overall financial structure. If you want your line to be increased, or there is another lender ready to come along as an additional resource, then you are back nearly at the same level of scrutiny you were during the initial solicitation. However, if by now you have managed to establish friendly relationships with your bankers, your path will be much easier.

PART

IV

Cash Must Flow: Treasury Management

You can be the richest person in the world, with billions in equities and unlimited credit lines. Yet, if for whatever troubled reasons you need \$20,000 in cash on Saturday night, you'd better have it under your mattress (the safe behind that Picasso will do, too). The same goes for any business. As a head of finance, you may have at your company's disposal buildings, factories, millions in inventories and receivables, and sizable credit lines. The business may be recording impressive profits that make your financial statements look very attractive. But none of it means that you will be able to meet your payroll requirements tomorrow, unless you carefully plan for it. That is why cash flow management is probably the most vital function of CFOs and controllers, especially in small and midsize companies.

The Gist of the Treasury Function

Generally speaking, there are two main facets of cash management as a functional concept. For the lack of better terminology, let me call them macromanagement and micromanagement. They are equally important and cannot be isolated from each other—successful macromanagement guarantees more efficient micromanagement.

Macromanaging of treasury deals with an entity's balance sheet liquidity. It targets the company's *working capital* (defined as a difference between *current assets* and *current liabilities*) and consists of efforts designed to increase this metric by building *cash reserves*. There is a certain dissimilarity in how different companies define the purpose of this process and determine levels of their monetary caches.

The financial community (and therefore the investing public) counts liquidity among one of the most important positive indicators in the evaluation of public companies. Thus, organizations with stocks traded on the open market and executives motivated by their stock options strive to raise levels of working capital.

I find it interesting that the majority of large companies, both public and private, come to view working capital as some sort of nest egg intended to assure the business's survival on a rainy day (frequently they even treat it in a very personal manner, investing in risky derivatives). This explains, though,

why in the times of economic distress there are always articles about the importance of cash management with quotes from *Fortune* 500 CFOs detailing their liquidity-enhancement programs and explaining that in the times of banks' tighter credit policies, they can rely on their own cash reserves. But as soon as the global economies rebound, the same executives pronounce working capital matters to be less relevant.

Seriously? In smaller companies there is never a time, rain or shine, when treasury concerns can be put on the back burner—this function is always on the top of the list. And you are a lucky and quite rare CFO if you can choose to build a long-term cash reserve. In the reality of a dynamic small or midsize business, the true purpose of liquidity improvement is to *ensure continuous positive cash flow* (i.e., to do whatever it takes to have your inflows exceed your outflows at any given moment).

The good news is that regardless of your reasoning for the betterment of the working capital movements, the integral parts of the action plan are identical:

- Faster current assets turnover—increasing rates of liquidating inventories into sales and converting receivables into cash (AR management is discussed in Chapter 19)
- Effective accounts payable (AP) management (also discussed in Chapter 19)
- Accurate cash demand forecasts via meticulous cash flow projections (discussed in the next chapter)

■ **Note** My experience working with complex treasury operations that involve a wide variety of inflow sources, numerous credit lines, multiple currencies, and sporadic demands of funds eventually led me to a conclusion: for practical purposes, it is necessary to incorporate a dynamic forecast of credit-line utilization into the cash availability planning. Every time the cash flow projection shows deficiency, I peg an applicable financing method to cover it, thus estimating in parallel my future borrowing capacity. An added benefit of this exercise is an ability to provide strategic support for operational plans—you can effectively assess the possibility of financially accommodating one or another development. For example, if a request for a new \$5 million transaction to be funded in two weeks comes, you can approve or reject it depending on the combined cash and financing availability.

Micromanagement of treasury, on the other hand, is the set of daily activities directed at satisfying your immediate cash requirements. Over the years I have come to define *immediate* as a five-business-day slice. With the advance cash projection serving as guidance, you, or your treasury group, can develop a concrete action plan for the next few days. It's a task that's perpetually rolling forward—from determining the current day's cash position to updating the remaining days and adding a new one.

At this level the treasury is not about educated guesses and anticipatory activities anymore. It is all about factual status and judgment calls. It is tightly interwoven with accounts-receivable, financing, and accounts-payable functions: starting with receipt processing through disbursement instructions. Of course, it goes without saying that no matter how accurate your forecasts are, there are always last-moment payment requests or inflow delays.

Every CFO or controller creates her own *daily treasury routine*, accommodating managerial, financial, operational, and whatever other considerations of a particular business exist. Nevertheless, there are basic steps that must be included in all of them:

- Cash position assessment (further discussed in Chapter 18)
- Determination of status of receipts in-process
- Finalization of disbursements lineup and instructions
- Administration of foreign currency instruments
- Execution of borrowing decisions to cover deficits or disposition of cash excesses.

Even though it is quite rare for a business operating account to have a minimum balance provision, the bankers like when significant balances are kept on depositors' accounts because they use the funds to cover their Federal Reserve requirements, or to invest, including in the lucrative interbank lending market. As much as I try to be friendly with our bankers, I always say that commercial CFOs and controllers *are not in the business of sitting on a pile of idle cash*. The company's money has to work for your organization, not make the banks richer. That is why I consider dealing with cash excess just as important of a matter as handling the deficits.

In fact, if at the end of the day your operational inflows exceed your immediate needs, you must act like a banker and deal with the leftover cash in the same manner they do—you can reserve a certain amount for an unexpected requisite and do one of the following things with the rest:

1. Utilize it to fund a *next-in-line operational transaction*, such as a material purchase, which may improve the production flow.

2. Pay down some of the interest-bearing liabilities to *reduce financing costs*.
3. Pay down some other debt to *free up bank or commercial credit*.
4. If none of these uses is relevant enough for operational or financial positions, then you must *invest the excess cash* to earn some interest income—another good way to offset some of the interest expense.

Unless it is a permanent reserve, which, as I said before, can be invested into whatever long-term instrument you find appropriate and safe, it is advisable to use a short-term, fast-liquidating option. You can go as simple as throwing it into a savings account through your online banking. Keep in mind, though, that you get only six free transfers a month back from savings into checking—after that you incur penalties for each additional transfer. I personally prefer various types of sweep accounts, which automatically transfer (sweep) funds in excess of the preset amount into, let's say, a money market account that can be accessed at any given moment.

A sweep account is just one of the treasury solutions in a bank's arsenal of products. In order to facilitate their clients' efforts to consistently meet cash demands, financial institutions offer various cash management services, which address many aspects of both macro- and micromanagement processes. These services are discussed in more detail in Chapter 20.

Cash Flow Projections

Cash projection is the most important treasury macromanagement tool. It is a dynamic report that extends into the future covering the time frame within the limits that should make sense for a particular business. The report's main purposes are

1. to provide you with a clear vision of whether the company will be able to meet its cash demands at any given point within the time scope of the forecast; and
2. to prompt you to take appropriate long-term (liquidity management) and short-term (borrowing and disbursements administration) actions ensuring that these demands are satisfied.

Generally speaking, these objectives are achieved through the accurate assessment of two basic cash movements: *inflows* and *outflows*.

Structural Concerns

There is no single predefined recipe for a universal cash projection design. I wouldn't say that every single company should reinvent the wheel—there are some general principles applicable to any business (they are outlined further in this chapter). Nevertheless, every CFO and controller should be mindful of specific features that may affect the cash projection configuration.

It's not just the question of the covered time period—many other factors influence the form and structure of this instrument, including the entity's business nature, maturity level, financial stability, operational cycle, and credit relationships. As a testimony to the considerable variety of these reports, both in form and substance, let me offer this bit of information: the sector of E&D CC consulting services dedicated specifically to the development of cash flow management solutions offers over 30 different Excel-based projection templates designed for smaller enterprises. They can be further adapted to particular features of each individual company.

Here are a few primary differential parameters that may impact the cash flow projection's layout:

- *Business nature* is the most influential aspect. Obviously, a cash forecast for a manufacturing company with multiple levels of outflows at various stages along the value chain will be different from that of an Internet company with most disbursements in overhead categories and advertising income.
- *Business complexity* affects the entire concept of cash flow. A straightforward commercial movement of, let's say, a wholesale company specializing in distribution of one particular type of products, will call for a simple design. On the other hand, some enterprises with multiple divisions may have business configurations so complicated that they would need a separate cash flow projection for each section.
- *Stage of maturity* (but not necessarily the age) dictates whether you can rely on the historical data in discerning the inflow and outflow patterns. An entity with balanced operational flow will allow for more reliable long-term forecasts; but for a growing, dynamic company, building even a short-term projection will be a hands-on process, sometimes requiring daily attention.
- In the absence of *outside financing*, companies depend entirely on their own cash inflows. They have to be more careful with timing their disbursements, trying to keep their payables current without creating negative balances in the projected future. The ability to cover operational deficits with borrowing resources provides the flexibility for time-saving fixed-check-run schedules and unplanned strategic deals.
- *Commercial tactics* play a significant role in cash flow cycles. Many companies, for example, acquire production raw materials or goods

for resale when the markets are low and hold on to those long positions for some time to make extra profits when the prices change. Clearly, special estimation techniques need to be applied in these cases in order to predict when these inventories will be liquidated and turned into receivables and then into cash.

- *Credit terms and payment forms* that a company offers its customers and negotiates with its vendors and suppliers are the most evident and some of the most crucial factors impacting the cash flow itself and the structure of its projection.

A company in the example illustrated by Figure 17-1 is a mature service company with Internet-driven revenue that generates virtually immediate cash through online credit card payments and service-fee income derived from the long-established customer base. The conventional customers either have fixed-price contracts or are billed on an hourly basis. There have not been any changes in the business operations for some time, and it allows the company to determine the exact pattern of their collections from all three types of revenues.

The AP disbursements are identical from one month to another, and the most significant (and slightly variable) category of operational outflows is the cost of labor. The company has an unrestricted \$500,000 revolving credit line, which it uses when there is a temporary deficit, and pays it down whenever there is a sufficient surplus. If, at any given point, the collections fall short of the expectations, it would be treated as a signal to initiate one or another measure of accounts-receivable management. All in all this is a very straightforward cash flow projection with a high level of predictability that allows for a long-term (in this case, six month) forward outlook. It can be extended at the end of each month. The example in Figure 17-2 is an altogether different animal. This is an international import/export company on a growth path, adding 40% to its volume annually for the past five years in a row.

Chapter 17 | Cash Flow Projections

Date	Inflows			Outflows			Net Cash Flow	Revolving Credit Line \$500,000	Owners' Distributions	Cash Balance	Contracted Engagements	
	Online C/Cards	Fixed Rate Engagements	Hourly Engagements	AP Disbursements	Commissions & Payroll	Payroll Tax					Fixed Rate Contracts	Hourly
Opening Balance										450,000		
07/01/11	16,500.00			36,475	33,000		(52,975)			25,000		
07/04/11							0					
07/05/11	16,500.00	29,631	258,469	4,775	191,000		108,825			(75,000)		
07/06/11	6,000.00			1,520		12,000	(7,520)				177,785	775,407
07/07/11	14,000.00			45,000			(31,000)					
07/08/11	10,000.00			-			10,000					
07/11/11	7,500.00	29,631		870			36,261					
07/12/11	7,500.00			8,910			(1,410)					
07/13/11	16,800.00			2,220			14,580					
07/14/11	9,500.00			3,861			5,639					
07/15/11	7,500.00	29,631	258,469	17,385			278,215			(100,000)		
07/18/11	14,000.00			1,520			12,480					
07/19/11	6,500.00			1,415	176,000		(170,915)					
07/20/11	3,500.00	29,631		3,635			29,496			100,000		
07/21/11	18,000.00			875			17,125					
07/22/11	2,000.00			13,460		10,000	(21,460)					
07/25/11	8,500.00	29,631	258,469	200			296,400			(100,000)		
07/26/11	22,000.00			-			22,000					
07/27/11	7,500.00			1,365			6,135					
07/28/11	4,000.00			6,275			(2,275)					
07/29/11	10,000.00	29,631		845		65,000	(26,214)					
08/01/11	23,000.00			36,475			(13,475)					
08/02/11	22,000.00			4,775	180,000		(162,775)					
08/03/11	21,000.00			-	41,000		(20,000)					
08/04/11	2,500.00			1,520			980					
08/05/11	17,000.00	26,667	200,000	45,000		10,000	188,667			(100,000)		
08/08/11	9,500.00			-			9,500				160,000	600,000
08/09/11	20,500.00			870			19,630					
08/10/11	14,000.00	26,667		8,910			31,757					
08/11/11	1,000.00			2,220			(1,220)					
08/12/11	21,000.00			3,861			17,139					
08/15/11	9,000.00	26,667	200,000	17,385			218,282					
08/16/11	11,500.00			1,520	181,000		(171,020)					
08/17/11	11,000.00			1,415		146,000	(136,415)					
08/18/11	3,500.00			3,635			(195)					
08/19/11	10,500.00			875		10,000	(375)					
08/22/11	17,000.00	26,667		13,460			30,207			100,000		
08/23/11	21,000.00			200			20,800					
08/24/11	16,000.00			-			16,000					
08/25/11	12,500.00	26,667	200,000	1,365			237,802			(100,000)		
08/26/11	10,000.00			6,275			3,725					
08/29/11	23,500.00			845			22,655					
08/30/11	21,000.00	26,667		4,470	181,000		(157,803)					
08/31/11	24,000.00			-			24,000					
09/01/11	3,500.00			36,475	44,000		(76,975)					
09/02/11	4,000.00			4,775		10,000	(10,775)					
09/05/11				-			0					
09/06/11	10,000.00	20,000	193,333	1,520			221,813					
09/07/11	2,500.00			45,000			(42,500)				120,000	580,000
09/08/11	14,000.00			-			14,000					
09/09/11	10,000.00			870			9,130					
09/12/11	2,000.00	20,000		8,910			13,090					
09/13/11	3,500.00			2,220	179,000		(177,720)					
09/14/11	3,500.00			3,861			(361)					
09/15/11	21,500.00	20,000	193,333	17,385		99,000	118,448					
09/16/11	11,000.00			1,520			(520)					
09/19/11	30,000.00			1,415			28,585					
09/20/11	13,500.00	20,000		3,635			29,865			100,000		
09/21/11	14,000.00			875			13,125					
09/22/11	6,000.00			13,460			(7,460)					
09/23/11	13,500.00			200			13,300					
09/26/11	21,000.00	20,000	193,333	-			234,333					
09/27/11	19,500.00			1,365	173,000		(154,865)					
09/28/11	25,000.00			6,275			18,725					
09/29/11	23,000.00			845								
11/30/11	21,500.00	13,333		4,470			25,155					
12/01/11	11,000.00			36,475	44,000		(69,475)					
12/02/11	22,500.00			4,775			17,725					
12/05/11	8,500.00	15,000	150,000	-			173,500					
12/06/11	22,000.00			1,520	168,000		(147,520)					
12/07/11	12,000.00			45,000			(33,000)					
12/08/11	17,000.00			-			17,000					
12/09/11	5,000.00			870		10,000	(5,970)					
12/12/11	1,000.00	15,000		8,910			7,090					
12/13/11	21,000.00			2,220			18,780					
12/14/11	3,000.00			3,861			(861)					
12/15/11	27,000.00	15,000	150,000	17,385		106,000	68,615					
12/16/11	5,500.00			1,520			3,980					
12/19/11	21,500.00			1,415			20,085					
12/20/11	3,500.00	15,000		3,635	168,000		(153,135)			350,000		
12/21/11	19,000.00			875			18,125					
12/22/11	15,000.00			13,460			1,540					
12/23/11	11,500.00			200		10,000	1,300					
12/26/11	-			-			0					
12/27/11	30,000.00	15,000	150,000	1,365			193,635					
12/28/11	21,000.00			6,275			14,725					
12/29/11	21,000.00			845			20,155					
12/30/11	25,000.00	15,000		4,470			35,530					
01/02/12	9,000.00			40,950			(31,950)					
11/30/11										668,495		
12/01/11										698,858		
12/02/11										629,383		
12/05/11										647,108		
12/06/11										820,608		
12/07/11										673,088		
12/08/11										640,088		
12/09/11										657,088		
12/12/11										651,218		
12/13/11										658,308		
12/14/11										677,088		
12/15/11										676,227		
12/16/11										744,842		
12/19/11										748,822		
12/20/11										768,907		
12/21/11										265,772		
12/22/11										283,897		
12/23/11										235,437		
12/26/11										286,737		
12/27/11										286,737		
12/28/11										480,372		
12/29/11										495,097		
12/30/11										515,252		
01/02/12										550,782		
										518,832		
											90,000	450,000

	Week of					
	6/20/2011 6/26/2011	6/27/2011 7/3/2011	7/4/2011 7/10/2011	7/11/2011 7/17/2011	7/18/2011 7/24/2011	7/25/2011 7/31/2011
Beg. Balance	2,450,324	2,098,238	820,269	697,388	1,272,315	2,716,012
Projected Receipts	4,178,231	4,210,153	3,578,630	3,864,920	2,898,690	1,250,000
Accounts Payable Disbursements		1,250,000		1,650,000		1,250,000
Payroll	245,000		245,000		245,000	
LC's and Bankers Acceptances Due	4,285,316	4,238,122	3,456,511	1,639,993	1,209,993	-
Cash	2,098,238	820,269	697,388	1,272,315	2,716,012	2,716,012
Unrestricted Credit Line Availability	319,669	386,629	1,336,429	1,941,429	2,371,429	2,371,429
Cash Plus Unrestricted Line Availability	2,417,907	1,206,898	2,033,817	3,213,744	5,087,441	5,087,441
Total Trade Finance Lines	15,702,040	6,699,164	12,744,265	10,950,232	10,009,619	13,920,396
Contracted Transactional Disbursements	13,221,232	7,176,131	8,970,164	9,910,778	6,000,000	3,000,000
NEW TRANSACTIONS AVAILABILITY	2,480,808	(476,967)	3,774,101	1,039,455	4,009,619	10,920,396
Cash Plus Lines Availability	4,898,715	729,931	5,807,918	4,253,199	9,097,060	16,007,838

Figure 17-2. Example of a six-week cash flow projection (courtesy of E&D CC)

Moreover, it trades listed commodities and depends on daily market changes. From time to time, it participates in “announced at random” open multi-million-dollar bids and holds long positions of inventories to be sold later for higher profits. The entity has an unrestricted credit line that can be used to cover any cash deficits and several trade finance facilities utilized for material purchases only via LCs and BAs. The inventory acquisitions, together with financing transactions, constitute the largest portion of the company’s disbursements. On the receivables side, the variety of terms is offered to customers, ranging from prepayments to open credit and everything in between. Even though the company enjoys sufficient liquidity, which allows it to bunch all accounts payable and payroll disbursements into orderly bi-weekly arrangements, the constant hunt for more business makes treasury activities somewhat hectic. This exciting, high-blood-pressure set of circumstances permits no more than six weeks of reliable projections of cash flow combined with credit utilization. And it is apparent that starting with the fourth week, changes must be expected. In fact, even though it appears that this report can be updated once a week, the business seems to be so active that I personally would attend to this forecast daily.

As different as these two illustrations are, their formats are dictated by certain fundamental principles—the common basic elements of a cash flow projection structure:

1. The predictability of inflows and outflows determines the extent of the forecast. Companies with stable and repetitive patterns of collections and disbursements can go several months forward. However, if the nature of the business makes predictions far in advance nonsensical, you should stick to a more feasible time span.

2. The operational cycle is the foundation of revenue generation. With a single exception of prepaid products and services, revenue recognition serves as the initial point in assessment of value and timing of cash inflows.
3. Sales credit terms, payment forms, and collection patterns drive the inflows forecasts. If you universally extend, let's say, 30 days of credit to your customers who generally pay with a 30-day delay, you can predict your March inflows based on January invoicing. This data also has a reciprocal value of letting you know where the efforts to improve receivables need to be concentrated.
4. If it is important to track inflows from different sources of revenue, they should be separated. One example would be inflows generated from sales of different product lines. The same goes for the types of receivables (credit cards vs. cash sales, foreign receivables vs. domestic, etc.).
5. Credit relationships with your vendors and suppliers, as well as forms of payments you use, particularly in trading transactions, dictate the arrangements of outflows.
6. The key outflows must be separated from other disbursements because they require special attention. For example, labor-intensive companies should be particularly concerned with meeting funding requirements for operational payroll; on the other hand, material purchases must be set apart for manufacturing and trading companies. You may also consider distinguishing between overhead and operational payables, as well as financing transactions, such as loan repayments.
7. Growing companies acquiring fixed assets and/or making capital investments should definitely designate a separate line or column for those activities for the sake of visual clarity.

Inflows and Outflows: Principle of Conservatism

The basic accounting principle of conservatism is just a more palatable way of saying “expect the worst”: probable losses must be recognized, but gains must not; the assets are stated at their lowest values; contingencies with possible payouts must be disclosed, but not those with a chance of awards; and so on. There is a reason why accountants are always depicted in cartoons

with long faces and mournful eyes—it is an accurate visual representation of the pessimistic realism we are implored to utilize as a proper evaluation technique in all cases. And thank you, our accounting forefathers, for that!

It is mandatory to employ the principle of conservatism when it comes to the assessment of projected inflows and outflows:

- Use the longest historical statistics for production cycles and inventory turnovers.
- Discount future revenues.
- Anticipate higher prices for purchases and increases in services' rates.
- Always add extra time for collections.
- Expect to make payments earlier.
- Build a cushion for extraordinary events and unexpected disbursements.

Adhering to these rules will result in the creation of a cash flow safety net, preventing the possibility of being strapped for funds.

Cash Forecasts Generated by Accounting Systems

The task of forecasting is only partially an exact science. Even the most advanced, custom-made program that studies the data and makes predictions based on past patterns cannot accommodate extraordinary events and momentary changes. There is some element of an intuitive art to this process, and that is why it is difficult to automate—it requires a hands-on touch, especially if you deal with a dynamic entity in a volatile market.

The majority of popular small-business accounting systems (QuickBooks and such) do not produce reports like that at all—you, your treasury group, or your financial analyst will have to design one, most likely in Excel, and then update it based on the data in the system, which can be exported and then manipulated. Writing macros may facilitate this task. If there is a lack of time and/or skills, you should outsource the development, but don't get sucked into buying an expensive report-writer just because you need this and few other reports. Instead, find people who provide solution-by-solution services. I can always suggest someone suitable to your needs through my blog, *The Frustrated CFO*.

If you have an expensive high-end program integrated with a sophisticated report developer, such as IBM Cognos, you may be able to create a cash

forecast that will be updated automatically every time you run the report. Without a doubt, these are the most time- and effort-efficient solutions. Nevertheless, a certain level of flexibility is lost there, due to the standardization of reporting features.

Midmarket programs, such as various packages within Microsoft Dynamics business solutions, all have prebuilt cash requirements queries. However, you must keep in mind that these reports do not actually have forecasting capabilities—they draw the projections based on the data already in the system. Therefore, unless you have all your anticipated outflows entered into the AP module, you will not be able to generate a six-month forward report.

My experience shows that even treasurers with complicated and powerful IT products at their disposal end up with a set of interconnected Excel spreadsheets that allow them to play with the data predicting cash flows.

Daily Cash Position

Cash position is a basis of the treasury micromanagement and the starting point of the corresponding routine described in Chapter 16. On a conceptual level, just like cash projection, it has a dual implication—on one hand, it's an evaluation process (the collection of data), and on the other, it's the delivery of information (the resulting report as a decision tool). As integral parts of the same task, they influence each other and must be designed together. In other words, you cannot create a step-by-step procedure for cash position assessment without deciding on the presentation format.

Developing this task, I always found the method of logical deduction to produce the best results—you start by envisioning the instrument that would consistently facilitate effective monetary judgment calls and then unspool the process of arriving at that desired outcome. This approach basically comes down to answering the following questions in this particular order:

1. What is the scope of daily treasury decisions? What are the actions that need to be taken to satisfy the cash management goals?
2. What kind of knowledge is mandatory to make these decisions? What are the crucial items of data required to accomplish this task?
3. What kind of presentation format will allow the most efficient utilization of this information in the decision-making process?

4. Who will be responsible for compiling the end report?
5. What are the timeframe restrictions to finalize all daily treasury tasks? This condition also dictates the deadlines for the position assessment and report(s) delivery.
6. Where does the necessary data come from? What are the original sources of the information?
7. How will the information be collected?
8. Who will be responsible for gathering each of the informational elements?

The answers to these questions will lay the foundation for designing your cash position task structure. Of course, the variations will be as plentiful as the number of companies out there. A multitude of business nuances can influence both the way the position is determined and the configuration of the report(s) you want to see before making your treasury decisions.

Unlike the dynamic cash flow projection with its approximation of the future outlook, cash position is a static report of present reality—a snapshot of right now. And like any photograph, depending on the subject matter, it could be as simple as a passport photo or as complex as Diane Arbus's creative insights.

There are successful companies with the simplest cash management setups: one checking account, one currency, one type of collections from customers with the same sales terms, and all payables paid by checks. Such a company may not need a cash position report at all. The entire treasury routine consists of few elementary steps:

1. Get the previous day's bank balance.
2. See if any customers' receipts are being deposited.
3. Schedule a check disbursement run based on the total availability of cash.

On the other hand, there are companies with complications at all stages of cash management: several currencies with foreign exchange exposure, multiple sources of daily inflows, spontaneous disbursements, and decisions with significant business impact every step of the way. For businesses like that, the aggregation of information on the status of various accounts in the banks around the world is a task of its own.

Moreover, the more difficult the cash matters, the more sensitive they are to the time factor. The United States is behind the rest of the world in time—

frequently you need to make decisions about your foreign accounts transactions before 9:00 a.m. Sometimes, time constraints play the most influential role in shaping the cash position procedures. Regardless of the complexity, the urgency of daily actions demands optimization of expediency, efficiency, and comprehensiveness of both the process and the resulting reports. You may be forced to trade absolute accuracy for timely performance.

Examples of Cash Position Reports

It is most illustrative to demonstrate the mechanics and the logic of cash position development by studying examples. Hopefully, the two presented following will provide you with some ideas about the basic principles you may employ yourself. I want to reiterate that the reports presented in Figures 18-1 and 18-2 are summary cash position reports used for daily treasury decision-making. These are final outcomes with data linked in from various schedules. More details on this process are provided for each illustration.

Illustration 1

as of: 6/27/2011		Bank 1 Account #1 HO Operations	Bank 1 Account #2 All Payroll	Bank 2 Account #1 Division 1	Bank 2 Account #2 Division 2	Bank 2 Account #3 Division 3	Bank 2 Account #4 Division 4	Incoming Collections (confirmed)
<i>Previous Day Balances</i>		26,896.20	3,204.16	484.72	3,690.26	8,559.67	9,092.98	Intraday 11,875.00
								28-Jun 4,005.00
								29-Jun 134,680.00
								30-Jun 37,650.00
<i>Outstanding Checks Float</i>		(38,645.58)	-	(1,882.24)	-	(757.57)	(4,051.25)	
<i>Outstanding Payroll & Payroll Taxes</i>			(3,176.01)					
<i>Upcoming PR (06/30)</i>			(103,169.11)					
<i>Approved for Payment:</i>								
<i>Rents & Utilities (Today)</i>		(6,100.00)				(2,500.00)	(4,500.00)	
<i>Phones (06/28)</i>		(2,570.00)						
<i>Health Insurance (06/29)</i>		(5,600.00)		(2,100.00)	(2,100.00)	(3,500.00)	(3,500.00)	
<i>Service Subcontractors (06/30)</i>				(7,580.00)	(8,625.50)	(14,175.25)	(14,302.50)	
<i>Total Outstanding Disbursements</i>		(52,915.58)	(106,345.12)	(11,362.24)	(10,725.50)	(20,932.82)	(26,353.75)	(228,635.91)
<i>Bank Surplus/(Deficit)</i>		(26,019.38)	(103,140.96)	(10,877.52)	(7,035.24)	(12,373.15)	(17,260.77)	
<i>Inflows Actions</i>								
Today		11,875.00						(11,875.00)
28-Jun							4,005.00	(4,005.00)
29-Jun		15,000.00	103,680.00	4,000.00		6,000.00	6,000.00	(134,680.00)
30-Jun		6,650.00		8,000.00	8,000.00	7,000.00	8,000.00	(37,650.00)
<i>Bank End-of-Today Balance</i>		38,771.20	106,894.16	12,484.72	11,690.26	21,559.67	27,097.98	
<i>Bank Balances</i>		30-Jun 7,505.62	539.04	1,122.48	964.76	626.85	744.23	11,502.98

Figure 18-1. Cash position report, illustration 1 (courtesy of E&D CC)

This is a company severely strapped for cash. It operates exclusively on its own cash flow with no borrowing resources. Moreover, the business's receivables are rigid—they are either generated on the spot through telephone sales or paid on scheduled days by contingency clients outsourcing the entity's services. This precludes any possibility for macromanaging of liquidity. It is what it is. These are difficult conditions experienced, in one way or another, by many companies today.

Under these circumstances, the single purpose of the daily treasury management and the cash position report is for the company's controller to pick and choose the most important payments for approval on a particular day, just to keep the company from shutting down. Sometimes, she is forced to authorize payments in excess of available cash, counting on the check float to clear after more cash comes through. The payments scheduling cannot go further than four days forward, limited by the ability to anticipate the collections. When receipts materialize, the controller throws them into different bank accounts according to calculated deficits.

The previous day's balances, outstanding checks, and intraday inflows are collected by one of the junior accountants from online banking reports. Accounts Payable is responsible for keeping the system's records very current, so that the controller can fully rely on the aging.

Illustration 2

This company's CFO is not concerned about meeting her requirements of covering operational accounts payable, overhead, and payroll. In fact, her AP department does not deal with payments in those categories of expenses on daily basis—they make weekly disbursement runs, and there is a semi-monthly payroll managed by a third-party provider. Sufficient funds are transferred on prescheduled days to cover these needs, as shown in the top section of the chart.

Here the ultimate purpose of the cash position report, and the cash management task itself, is to ensure smooth conduct of the company's business through decision-making processes that yield sufficient payments or various forms of financing for the company's acquisitions of inventories. Everything is focused on transactional support: the control of receivables, efficient service of the credit lines, and foreign exchange) administration. All become integral parts of the action plan and are interconnected within this summary.

The previous-day's bank balances and intraday positions are drawn from reports produced within domestic and foreign banks' online treasury systems.

DAILY FINANCIAL POSITION REPORT						
Monday - Jul 11, 2011						
	Previous Day	11-Jul	12-Jul	13-Jul	14-Jul	15-Jul
US Dollars Position						
<i>Account 1: Operational AP & Overhead</i>						
Bank Balance	72,715.41					
Book Balance	9,801.97		11,551.97	11,551.97	11,551.97	12,989.18
Weekly Disbursements Run		(198,250.00)	-	-	-	-
Semi-Monthly Payroll		-	-	-	(86,562.79)	-
Cash Requirement:		(188,448.03)	-	-	(87,010.82)	-
Actions:						
Transfer From Transactional Accounts		200,000.00			100,000.00	
<i>Accounts 2-4: Transactional Receipts & Disbursements</i>						
Bank Balance (from overnight sweeps)	877,322.34					
Book Balance	857,068.36		825,885.36	122,841.76	277,432.67	683,993.65
Receipts:						
Intraday Cleared	1,158,960.00					
Domestic Checks Collections (Remote Deposits)	158,567.00	100,000.00	100,000.00	100,000.00	100,000.00	50,000.00
Domestic Collections - Wires		225,000.00				75,000.00
Foreign Collections - Wires		762,596.25	471,817.85	1,413,995.00	583,397.50	
Foreign Collections - Sight LC's and CAD		146,300.00	110,400.00	65,100.00		115,140.00
Foreign Collections - Forfeiting		-	598,000.00			
Disbursements:						
Sight LC's Payments	(378,610.00)	(285,075.00)	(701,875.00)	(362,825.00)	(638,055.00)	
Term LC's Payments				(80,840.00)		
Bankers' Acceptances	(170,120.00)	(1,468,846.25)	(923,751.94)	(80,299.02)	(896,250.00)	
Open Credit Payments Due		(225,768.00)		(368,570.00)		
FOREX Hedging Contracts Due		(957,050.60)				
Transfer to Account 1	(200,000.00)				(100,000.00)	
Transactional Pipeline	(1,822,058.00)	(3,500,000.00)			(685,000.00)	(1,795,350.00)
Cash Requirement:	(496,172.64)	(4,377,158.24)	(222,567.33)	188,993.65	(1,622,123.85)	
Actions:						
Authorize LC's - Credit Line 1	122,058.00	1,150,000.00			175,000.00	55,350.00
Borrow - Credit Line 1	200,000.00	1,000,000.00		500,000.00		
Authorize LC's - Credit Line 2		900,000.00			510,000.00	340,000.00
Borrow - Credit Line 2	1,000,000.00	1,800,000.00				1,400,000.00
Prepay:						
Foreign Currencies Position						
<i>Accounts 5-8: Euro</i>						
Current Rate:		\$1.4033				
Bank Balance	152,162.99					
Book Balance	152,162.99		344,762.99	344,762.99	152,162.99	57,162.99
Receipts:						
Collections	-	192,600.00				
FOREX Hedging Contracts Delivery		-	682,000.00			
Disbursements:						
LC's Payments		(682,000.00)				
FOREX Hedging Contracts Due				(192,600.00)		
Transactional Pipeline - bilateral					(85,000.00)	
Transactional Pipeline - unilateral						(356,000.00)
Cash Requirement:						(356,000.00)
Actions:						
Cover Contract Delivery from Transactional Account			682,000.00			
Transfer USD from Transactional Account for Spot Purchase						
Hedge unilateral transactions						356,000.00
Credit Line # 1						
Current Utilization	22,892,038.00					
Current Availability	4,107,962.00	4,107,962	3,956,024	2,386,096	2,733,007	2,618,847
Transactions to Close:						
Sight LC's				701,875.00		
Term LC's					80,840.00	
Bankers' Acceptances	170,120.00	580,071.50	145,036.63			896,250.00
New Utilization:						
LC's	(122,058.00)	(1,150,000.00)			(175,000.00)	(55,350.00)
Bankers' Acceptances	(200,000.00)	(1,000,000.00)	(500,000.00)			
Credit Line # 2						
Current Utilization	20,339,433.00					
Current Availability	11,660,567.00	11,660,567	11,039,177	9,863,027	10,641,742	10,574,866
Transactions to Close:						
Sight LC's	378,610.00	285,075.00			362,825.00	638,055.00
Term LC's						
Bankers' Acceptances	-	888,774.75	778,715.31	80,299.02		
New Utilization:						
LC's	-	(550,000.00)			(510,000.00)	(340,000.00)
Bankers' Acceptances	(1,000,000.00)	(1,800,000.00)				(1,400,000.00)

Figure 18-2. Cash position report, illustration 2 (courtesy of E&D CC)

■ **Note** Because this company's transactional accounts sometimes carry significant balances, they are all set up with an overnight sweep feature—all funds above \$100,000 are invested overnight and then returned to the account before the beginning of the next banking day.

Accounts Receivable and Collections groups feed the information about all check and wire payments in both currencies into their schedules, which link into the corresponding cells in the summary. In a similar fashion, the Trade Finance group maintains details on export and import LCs and documentary collections, as well as the maturity dates of bankers' acceptances. For instance, on July 11, a banker's acceptance payment of \$170,120 is due for repayment to Credit Line 1. It is reflected as a negative number in US dollar disbursements, but it also adds back to the availability of the credit line, so it is a positive number in that section. Accounts Payable's schedule automatically updates open credit payments according to their due dates. Finally, the transactional pipeline comes from the operational side of the company's system, where transactions are ranked in order of strategic priority.

Populating beginning balances, receipts, disbursements, and credit line payoffs with all this data provides the treasurer with the daily cash requirements, as well as the credit availability for the next five days. After verification and approval of the requested payments, the action plan is devised with regard to which credit line to use for each new transaction. Based on these decisions, the instructions are distributed to the Trade Finance group and operations managers. On July 11, the scheduled disbursements (\$378,610 + \$170,120 + \$200,000) and authorized new transactions (\$1,922,058) are satisfied from the cash availability (beginning balance, plus receipts) and the issuing of the \$122,058 LC and borrowing \$200,000 from Credit Line 1 as well as borrowing \$1,000,000 from Credit Line 2.

As you can see in the foreign currency section in Figure 18-2, one of the new deals is a unilateral foreign currency transaction, which means that the material will be purchased in euros, while distribution will be in US dollars. In order to protect the company from the currency exchange risk, a hedging contract is taken. As a result, when the payment to the supplier will be made, regardless of what happens to the currency market, the exchange rate for this transaction will be fixed. (You'll find more details on foreign exchange risks in Part VII of this book).

■ **Tip** This seems like a good place to mention the tricky nature of foreign currency balances. For financial statement purposes, at the end of fiscal periods the control balances need to be converted into US dollars at the published rate of the moment. This applies to cash, receivables, and payables. Depending on the rate's behavior during the period, it may result in losses or gains. If there is a foreign exchange hedging contract in place, its restatement at the same rate will balance those changes to some extent. This frequently happens with leftover cash balances. I always suggest being mindful of this possibility and disposing of the cash before the end of the period—there are always some bills you can prepay.

Clearly, with wires going from different international banks to various countries, foreign currency transactions, and bank communications about different financing instruments, cash micromanagement of this complexity is a time-sensitive matter: every bank has separate cutoff times for each different function, and for some transactions, a one-day delay is a deal-breaker. In this company, the deadline for having all supporting information updated in the cash position report is 11:00 a.m., and all decisions are made by noon.

Whether your cash management process is intense or simple, the daily cash position report is a valuable tool that brings together all the data you need for making important treasury decisions in a sensible, logical manner.

Managing Receivables and Payables

My grandfather used to say, “Live within your means and don’t spend the money you don’t have in your pocket.” On the surface it may seem like an old-fashioned point of view, but it is essentially the golden rule of liquidity, applicable to individuals and business entities alike. Let’s face it, if everyone lived by this precept, the global credit crunch wouldn’t have happened. Keeping expenses below revenues and collecting receivables before paying bills are two strategies that together guarantee positive cash flow. Of course, it is easier said than done.

Ideally, we would be happy if our customers prepaid in advance while our vendors extended us 360-day credit. If that were the case, we wouldn’t be seeking the means of financing discussed in Chapter 12; growth capital would become the only external funding need. But this is not possible, because it’s not just us—all businesses want the same thing. Our suppliers would prefer prepayments as well, while our customers seem to be accepting products and throwing the bills away. So, to establish more-or-less normal commercial relationships, everyone needs to compromise: we work hard on obtaining the best credit terms for our employers, on minimizing the risks of extending credit to others, and on getting paid at least with reasonable delays.

In other words, we are forced to manage receivables and payables. It is unavoidable because open credit goes hand in hand with the potential to generate more revenue. The more liberal the credit terms, the higher the sales. And there is nothing we can do about it except for trying to find an optimal balance between the risks and the volume ambitions. The good news is that it works both ways: our suppliers extend us credit because they want more sales as well.

In fact, the dynamics of credit terms are dictated by the basic economic rule of supply-and-demand. In other words, they are determined by a company's industrial positioning. And it is important to understand where you stand in order to manage your receivables and payables effectively.

The ideal situation described in the second paragraph can occur under the conditions of simultaneous excessive supply of the materials a company needs and unlimited demand for its own exclusive product with no competition in the marketplace. Then both the vendors and the customers are knocking on the door agreeing to whatever terms this championed enterprise may command. This can only happen with companies in possession of unique technologies. For example, if someone comes up with a way of making highly efficient and low-priced fuel out of carrots, the growers will extend them whatever credit they want, while wholesale distributors will be willing to pay on delivery. Of presently existing companies, I would name Apple, with its iPhones and iPads, and Google, with its AdWords and AdSense programs, as rare examples of entities with preferential treatment by both suppliers and customers.

For the rest of us, the story usually follows one of these scenarios:

1. In the industries with a few big players on the supply side, the scarce sources of products are far more important than the customers, and you must nurture your relationship with them. And if the nature of the product is such that you can always find someone to buy it, you can afford to be choosy about the extension of credit. Under these circumstances, losing a slow-paying customer is not that big of a deal. A good example of a business like that would be wholesale distribution of a soft commodity such as sugar, for which only several countries in the world supply the raw materials, and the refining process is concentrated in the hands of a few conglomerates.
2. The situation is reversed in the industries where a few big-box chains monopolize the majority of the consumer market. Barnes & Noble, Amazon.com, and Wal-Mart not only mandate severe discounts of books, but also command whatever credit terms they may

need from publishers. Thankfully, there is no shortage of writers willing to work on a contingency basis.

3. Finally, it is possible—but would be a very foolish commercial move—to find yourself in a position of having to rely on a limited number of suppliers while at the same time having claim only on a small market share. You can kiss liquidity goodbye.

A few years ago I was invited by my CEO to attend a session of his TEC group (The Executive Committee, now known as Vistage¹) dedicated to commercial relationships. Curiously enough, the composition of that particular group was skewed toward owners of businesses with limited payables and long lists of credit sales customers. They all shared concerns about improving their collection cycles (that is why I was invited). All except for one: there was an entrepreneur in the group with a reverse situation—a retailer with a very long accounts-payable schedule. During discussion she said, “Well, I just stretch everything to 120 days regardless of the terms,” and a dead silence fell. Everyone just stared at her. She couldn’t understand why the rest of the group was so offended until I explained that she was basically creating a cost-free financing for herself at the expense of her commercial partners’ liquidity.

Credit Receivables

There are three potential stages in the management of credit relationships with customers:

1. The new customer presale stage, which starts with risk evaluation and ends with either an approval of a certain credit line or a denial.
2. Continuing credit relationships with existing customers, which include collecting, monitoring of the established line’s utilization, and occasional revisions.
3. The unfortunate reality of handling delinquency and bad debts.

These three components of the credit function are discussed in more details following.

¹ Vistage (formerly TEC) is a membership-based international executive leadership program that specifically targets owners/CEOs of small and midsize private companies. Its members meet in small peer advisory groups once a month for discussions of various topics under the guiding principle of achieving better performance results.

Extending Credit

This is where the foundation of successful receivables management is built. By making correct judgment calls when extending open credit, we ensure healthier future cash flow and reduce the possibility of bad-debt losses.

The most important prerequisite of a fruitful customer credit function is the establishment of a *credit application procedure* for the sales department. There has to be a very good understanding among salespeople that no order for a new customer will be considered unless it is accompanied by a fully completed credit form—something like the example presented in Figure 19-1. It only makes common sense for a person who offers a product to a customer with an option of 30, 60, or 90 days payment delay to ask them to fill out this form—they are already talking anyway. If this opportunity is missed, then someone from your credit department will need to waste time looking for the person responsible for credit information, explaining the reason for the request (the new order most likely will not be in their system yet), and so on.

Regardless of the actual format, besides the prospective customer's name and full address, the credit application should provide the reviewer with information sufficient to conduct the most crucial steps of the credit-risk evaluation. This information is covered in the following subsections.

EIN (Employer's Identification Number) for Credit Insurance Coverage

I am a big proponent of obtaining a business credit insurance (aka trade insurance, aka accounts-receivable insurance) policy. Statistically speaking, anyone with open credit receivables of more than \$2 million will benefit from protecting themselves from possible bad-debt losses.

The largest provider of domestic and export credit coverage in North America is *Euler Hermes ACI*. American Credit Indemnity (ACI) was a dominant domestic player for decades, and it only makes sense that it was eventually acquired by the world's largest trade insurance provider, Euler Hermes, which pretty much shares the world market with another competitor—Coface Group. I have used ACI since the times when we had to dial into their automatic telephone system to obtain instant coverage or initiate a credit review. Now there is a beautiful online system, EOLIS, which performs the same functions in an interactive mode.

COMPANY NAME

CREDIT APPLICATION

GENERAL INFORMATION		
COMPANY NAME - DBA (To be shown on invoice): _____		
D&B D-U-N-S NUMBER _____		
MAILING ADDRESS: _____		
STREET ADDRESS: _____		
CITY: _____	STATE: _____	ZIP CODE: _____
TELEPHONE NO.: _____	D-U-N-S NO.: _____	FAX NO.: _____
IN BUSINESS SINCE: _____	BUSINESS YEAR ENDS: _____	TAX ID NO.: _____

TYPE OF BUSINESS		
CORPORATION PUBLIC _____	PRIVATE _____	
PARTNERSHIP: GENERAL _____	LIMITED _____	PROPRIETORSHIP: _____

OWNERS OR OFFICERS		
NAME: _____		
POSITION: _____	% OWNERSHIP: _____	
NAME: _____		
POSITION: _____	% OWNERSHIP: _____	
NAME: _____		
POSITION: _____	% OWNERSHIP: _____	

BANK REFERENCES		
NAME & ADDRESS: _____	FAX: _____	
BANK ADDRESS #: _____	CONTACT: _____	PHONE: _____
NAME & ADDRESS: _____	FAX: _____	
BANK ADDRESS #: _____	CONTACT: _____	PHONE: _____

TRADE REFERENCES (Show Major Suppliers Only)		
NAME & ADDRESS: _____	FAX: _____	
ACCOUNT #: _____	CREDIT CONTACT: _____	PHONE: _____
NAME & ADDRESS: _____	FAX: _____	
ACCOUNT #: _____	CREDIT CONTACT: _____	PHONE: _____
NAME & ADDRESS: _____	FAX: _____	
ACCOUNT #: _____	CREDIT CONTACT: _____	PHONE: _____

CREDIT REQUIREMENTS		
AMOUNT OF (\$) CREDIT REQUIRED: _____		
ESTIMATED MONTHLY \$ REQUIREMENTS: _____		

SIGNATURE	TITLE	DATE
_____	_____	_____

Please include most current audited financial statements

Figure 19-1. Example of a customer's credit application

For me personally, the biggest advantage of having credit insurance is not the possible loss coverage, but the opportunity to drastically cut the time and cost of credit research by tapping into the vast and thorough knowledge accumulated within the ACI system. I am usually opposed to the notion of

“industry experience” as a recruitment requirement (an expert should possess transferable professional skills), but when it comes to credit management, the support of an entire organization with a hands-on knowledge of individual customers in your particular market is invaluable. Credit insurance companies employ pros with very specialized sets of expertise focused on separate industries (factors do the same, by the way). Sometimes, you can call a reviewer about a customer, and in a heartbeat he’ll give you the entire history of the entity in question. The combination of an in-house credit manager’s efforts and an insurance provider’s resources prove to be indispensable for achieving the best results. Also, if the insurance provider declines to cover a customer, that’s a warning. They might be more conservative than your company is, and you may end up extending a credit line anyway, but at least it will put you on alert.

One of the significant responsibilities of the credit insurance policy administrator is periodic reporting on the payment patterns of covered customers. It is not a good idea to neglect this task, as the provider incorporates the collected data into its system, which improves the quality of the information it uses to determine business creditworthiness.

D-U-N-S Number, to Review the Company’s D&B Report

Dun & Bradstreet (D&B), which is over 170 years old, is another company I’ve been using since pre-Internet times. The subscription to its services used to involve receiving enormous books filled with listings of companies in an incredibly small type. Presently, their global commercial database contains 195 million business records compiled into beautifully streamlined reports, which can be accessed online from anywhere in the world. It is my opinion that a D&B subscription is advisable for any entity with more than 30 customers, and is absolutely mandatory for those who work hard on expanding their market shares.

Nowadays, D&B offers a variety of supplemental services, but its unmatched core value still lies in the collection and analysis of financial data and payment records of the listed companies. D&B’s proprietary algorithms assess credit capacity, payment trends, and financial strength, yielding four essential indexes: D&B Rating, Credit Score Class, Financial Stress Class, and 12-Month D&B PAYDEX. The D&B *comprehensive report* also includes aged payment summary by vendors’ industries, detailed payment history, all public filings, history of operations, and whatever banking and financial information D&B’s in-house scouts were able to obtain.

You can derive some interesting insights about a company even from the business summary that starts every comprehensive report. You may find out, for example, that the prospective customer is a subsidiary of another company, which is owned by the CEO's father. This may give you an understanding of the dynamics within the company.

Bank References

Due to privacy concerns, the information a bank officer can divulge is limited. Yet, at the very least you will be able to ask about the demand accounts' average balances, as well as inquire about the existence and extent of credit lines. Keep in mind that most banks' regulations demand a client's formally executed release of information, so if collecting banking references is your common process, you are better off asking for the release right away.

Trade References

Ideally, it is most meaningful to collect references from companies similar to yours. In reality, however, these companies could be your competitors, and the customer may not want to publicize the fact that he is looking for a new vendor. The second best option is to match the order volumes. Clearly, if you are considering a \$200,000 credit line, references with less than \$20,000 maximum exposure will not be good benchmarks. I recommend creating a reusable form with questions covering basic information such as the following:

- Inception of credit relationships
- Credit line size
- Highest credit achieved
- Last sale
- Current outstanding balance
- Average payment record

Other Important Information

The *company's ownership structure* is important for understanding the extent of personal responsibilities and for assessing the possibility of asking for the owners' personal guarantees.

Finally, always ask for *current audited financial statements*. Whether you get them or not, however, is a different question. It is easier with public

companies whose Q-Is and K-Is are always available for viewing. But private companies don't really need to share their financial information with anybody. It is up to the credit manager to convince them that having their statements will have an impact on the credit decision. If privacy is the customer's concern, you can always offer an NDA (nondisclosure agreement).

If your credit staff has exhausted all possibilities of establishing the credit line for a new customer, and upon review you agree with their decision and opt not to take the risk, don't just bounce the order back to sales. See if the customer will be willing to start the relationship on some other terms, like partial prepayment, or installments. After all, facilitating revenue generation is a part of your strategic mission.

Ongoing Credit Monitoring and Collections

Staying on top of the receivables turnover is probably your most important cash management tool. And it all comes down to establishing strict monitoring and quick-response procedures. This includes mandatory monthly statements, frequent aging reviews, and a hierarchy of danger alerts complemented with precise action instructions, such as the following:

- *Fifteen days past due:* AR distributes a duplicate statement.
- *Thirty days past due:* A collector makes a collection phone call or writes an e-mail to the customer's AP manager.
- *Forty-five days past due:* Credit manager alerts the sales department and issue a moratorium on new shipments.
- *Sixty days past due:* One of senior managers (maybe even a controller or CFO) calls a person holding a similar position in the customer's organization. If at this time financial troubles are disclosed, try to negotiate a repayment deal (a series of postdated checks, a signed repayment schedule, etc.).
- *Seventy-five days past due:* Credit manager issues a placement-for-collection warning letter. Euler Hermes ACI supplies its clients with a thick pad of very officially looking forms, but it is not difficult to compile your own.
- *Ninety days past due:* Consider this a delinquent account and deal with it accordingly.

Remember, the tighter your criteria of lateness, the greater the speed of collections. However, one has to be well versed in the fine art of balancing gentle pressure for promptness and good communications with repeat buyers.

Real-time updates of customers' files with invoices and approved—but not shipped yet—orders is highly important for keeping the credit line utilization within established limits. If something is not recorded, you run the risk of increasing exposure beyond the acceptable criteria.

The biggest challenge of continuing-customer relationships comes when a demand for a *credit line increase* arises; not because it sends you back to the drawing board—now that your company has established its own history, that job becomes easier. However, as a CFO or controller you must not give into the sales department's desire to satisfy every order that comes along. The danger of shoving too much credit down a customer's throat lies in the possibility of reaching a point when even a well-paying customer starts delaying remittances.

Many companies liberally offer prepayment discounts as means of improving liquidity. And that is fine as long as the cost/value correlation makes sense. When a company offers net 30 terms with a 2% discount for payments made in 10 days, it equates the cost of money to 36% per annum, which is pretty high. It's definitely not a good idea to offer prepayment if you have access to financing priced at LIBOR + 2%.

Dealing with Delinquency

Bad debts are terribly damaging, especially to companies with narrow margins. If your net profits run around 3% and one of your customers defaults on a \$100,000 receivable balance, the company will need to generate \$3 million in additional revenue to make up for it.

If you do have a credit insurance policy and the customer was covered, you can place a claim in accordance with the schedules provided to you by the underwriter. The claims are usually paid within 60 days for domestic debts and somewhere between 90 and 120 days for foreign debts. Of course, as with all insurance, the history of frequent claims will affect your renewal premium rates.

There are also collection agency or specialty law firm options. They offer their services on contingency basis, which means that you don't pay anything upfront while they do their work. To compensate for that, they charge 30 to 40% fees on collected amounts. This is a last resort, and it should not be utilized unless you are absolutely certain that there is no possibility for your company to collect the debt.

If your customer has filed for bankruptcy and your receivables were recorded on his books, you will be notified by the court of the proceedings.

Unless the outstanding balances were quite significant, it is unlikely you will be able to recover anything. In the hierarchy of debts, open credit payables are classified as the lowest priority because they are unsecured.

My very first boss, a fourth-generation manufacturer and wholesaler whose family has been dealing with retail customers for over 120 years, used to tell me that the best way to get back at a customer who did not pay you is to sell to them again, but on terms beneficial to you. Some businesspeople manage to bounce back after falling into trouble, and if your company's product is what they need, they will come back to you. Here is your chance to improve your liquidity by offering them stricter terms citing the past precedent, even if they are covered by credit insurance.

Credit Payables

I don't know whether that member of the TEC Group I mentioned before is still in business. Hopefully, she revised her wicked ways and her company is operating successfully. The economy cannot really afford to lose any entrepreneurs, but stretching payables and floating checks (like the company illustrated in Figure 18-1 in the previous chapter) is definitely not the way to go. A lot of companies experience cash flow problems, yet for many of them jeopardizing their credit power can mean an instant destruction of the business.

In fact, the best way to manage your payables and improve your liquidity is by perfecting your credit scores. Just think what would make an ideal customer in your book, and use those very criteria to become one for your vendors and suppliers:

- Build good relationships with credit managers, and willingly cooperate when they go through their credit reviews.
- Design efficient payables procedures—don't let sloppiness impair your credit. It is very sad when a company has sufficient cash availability, but is late with an important payment just because someone in payables screwed up. When payments are made by check, make sure that they go out at least a week before the due date to arrive on time.
- Pay special attention to big-name service providers, such as phone companies and utilities; they have designated employees whose job is to report on your lateness.

D&B has done an excellent job helping companies set up their credit-worthiness. They even have products specifically designed for small businesses with services dedicated to building a credit profile, establishing business credit, and managing creditability. If your own D&B report looks good, don't wait for your creditors to obtain one (for all you know they may not have a subscription and you cannot rely on other people's proficiency). Take the matter in your own hands: make a copy and send it to them. It will pay off in the long run—all these efforts will build a foundation for your ability to negotiate better credit terms with your vendors, and thus improve the company's liquidity.

The *strategy* of enhancing your cash flow should always be targeted at having a *positive terms gap* between the ones you receive and the ones you give your customers. If the latter are 30 days, then you should strive for the former to be at least 60 days.

And the *tactics* for negotiating more preferential terms with vendors and suppliers should be targeted on what I call "going one better." In other words, if you've been paying promptly with 30-day terms, go one step further and ask for 45 days, and then for 60. If a supplier has been demanding prepayments for years, maybe you can offer paying with LCs. If sight LCs have been the primary arrangement, a term draft could be a next step, or even better, a standby LC (a much cheaper instrument) as a security against an open credit. You get the idea.

■ **Caution** Don't put off a credit manager on the other side of the negotiation by saying that you want to improve your liquidity—that's for you to know. Find another reason for needing better terms: growth strategy, market share expansion, and so on—positive explanations that also have a connotation of more business with the vendor.

If you do find yourself in a cash-tight situation, try to prioritize: vendors that have the power to halt your operations should come first, then the ones who charge dizzying late fees, and so on. Many financial managers hide away from collecting vendors during difficult times, but the truth is, your trading partners don't want bad debts either. Work with them; try to negotiate extensions or installment payments. I hope, though, that you will never need to do that.

Treasury Management Services

In 1997, I was asked to take part in a focus group initiated by, as the invitation suggested, a “large financial organization,” for a discussion on treasury services. It did not take the participants too long to figure out that besides everyone’s involvement with cash management, the only other thing we had in common was that we were Bank of America clients. This was a time when direct modem dialing into the bank’s treasury portal in order to access your balances and initiate wire transfers was considered a cutting-edge service—many of our colleagues were still faxing their wire requests. But the moderator’s main task was to survey our willingness to go a step further. Would we feel comfortable forgoing our beloved dial-up connections and get to our accounts over the World Wide Web? Really? Just like that—go onto Internet Explorer, and enter a web address and login? We debated the possibility for four hours.

Today it’s impossible to imagine doing it any other way—all banks offer web-driven services. Moreover, they compete with each other on the quality, breadth, variety, and pricing of online instruments. When First Union merged with Wachovia in 2001, one of the main reasons for the transaction

itself and the adoption of the smaller company's name was the customers' satisfaction with Wachovia services, especially its online products.

No one can deny the impact that online tools have on the very meaning of real-time liquidity management. The ability to attend to the cash needs of a New York company from Amsterdam, Istanbul, Tokyo, Milan, Athens, St. Louis, Buffalo, or the hospital bed has redefined the notion of expediency. It has resulted in an otherwise rarely achieved balance between the urgency of the tasks and the capability to accomplish them.

This chapter, while giving its due to bank account administration, will take a broader approach and explore other treasury-related products and their impact on a company's liquidity. The Internet has sprouted a whole universe of non-banking providers delivering various combinations of treasury services to their customers. As a matter of fact, some of these companies have been able to carve out their own niches by developing specialized technologies and outpricing large banks out of several payment-processing services.

Demand Deposit Account Services

When it comes to managing bank accounts, the main concerns are fairly basic and self-explanatory:

- Ability to obtain information as close to real time as possible
- Immediacy of funds availability at your disposal
- Ease and expediency of executing transactions such as account and wire transfers, automatic payments, and so on
- Options for profitable utilization of concentrated balances
- Diversified reporting functions

With these considerations in mind, an executive wearing a treasurer's hat should be aware of the principal difference between regular *online* (and now *mobile*) banking—which is offered to corporate and individual customers alike—and a true *business treasury solution*. No matter how sophisticated and user-friendly the former is, its design and technological capabilities emulate a visit to a local branch. Most of the transactions that can be initiated while standing in front of an ATM machine, a teller's window, or a service representative's desk can be accomplished through online banking (although our computers don't spew cash yet). Yet, that plastic shield that separates visitors from the bank's entrails is still there when you use the generic Internet portal of a bank. So, for example, when you enter a wire transfer request, it is no different from handing a wire transfer paper form to a teller—figuratively speaking, it goes into an inbox and waits to be taken inside.

On the other hand, a treasury management service takes you behind that shield and lets you look at the screens and make entries into the fields accessible to the bank employees; it brings you several steps closer to the Fedwire (the Federal Reserve Wire Network), a *real-time funds transfer system* that enables its members (pretty much all banks) to electronically transfer funds to each other. Here, when you initiate a wire transfer, it goes straight into the wire room, and you immediately obtain a unique Fedwire reference number. The system lets you see the incoming funds as soon as they are executed within the Federal Reserve network. Moreover, they are available to you immediately. Most such cash management products have a comprehensive automatic payment interface and multiformat reporting functionality, as well as such add-ons as stop payment and check copy requests.

If you end up not disbursing all cash during the day, the best way to prevent accumulated balances from just sitting there idly, while at the same time preserving their liquidity, is to use the bank's overnight investment opportunity. By linking your business account to a *two-way sweep service*, you can automatically invest all funds in excess of the predetermined reserve overnight. The banks usually offer several investment options, including money market funds, repurchase agreements, and Eurodollar deposits.

Alternatively, a *controlled disbursement* setup can be used. It costs more in maintenance fees, but it maximizes the investment gains. Under this option, you can see your checking balances at the beginning of the day as well as the total payments coming through for clearance, funding just enough to cover the necessary sum. The rest remains in the investment account.

■ **Note** Large international corporations with multiple accounts in various financial institutions around the world have further options for enhancing their bank flow management, either by using single-portal solutions for multibank pooling, or acquiring their own SWIFT (Society for Worldwide Interbank Financial Telecommunications) memberships, which allow them to exchange standardized financial messages directly with their bankers.

CFOs and controllers frequently end up utilizing account services of the banks that provide them with credit facilities. That leaves you to choose from whatever products they have in their service portfolio. But, if you are not bound by such requirements, and are concerned with improving liquidity, you should look for the best treasury management services offered. In January 2011, *Global Finance* magazine named Citi a global winner as a best

overall bank for cash management. Bank of America Merrill Lynch (a subsidiary of Bank of America) got the first ranking in the same category for North America, while Wells Fargo was named the best in the combined quality of collections and payment services.

Receivables Solutions

Regardless of all the bells and whistles different providers use to dress up their offerings, all solutions related to collection of receivables are differentiated by the customers' choices of payments. Consequently, they fall into two main groups:

- *Those that must be ultimately processed by a bank:* These include incoming wire transfers, ACH (Automatic Clearing House) credit payments initiated by customers from their accounts directly into a payee's account, and check payments. They are discussed in this section.
- *Those that can be processed by merchant service providers (not necessarily banks):* These include payments by credit and debit cards, and e-checks. They are discussed in the next section.

Wire transfers and ACHs generated by your customers are straightforward payments—all you need is to provide the payers with the bank's routing number (a.k.a. ABA [American Bankers Association] number) or a SWIFT, and the beneficiary's account number.

Some readers may be surprised to know, though, that in the United States, checks still remain the predominant method (used in about 60% of cases) of paying bills both by business payers and individual consumers. Yet it makes perfect sense in the psychological context of liquidity management, especially for those who experience cash flow difficulties. It is basically a form of stretching: on one hand the check is cut, but on the other, there is still mailing time, depositing, float, and so on to deal with.

To counteract these delays and improve their own liquidity, payees have always been looking for ways to speed up check processing. For a long time there was only one product available for this: the *lockbox*. A lockbox is simply a PO box accessible by the bank and specifically designated to receive a client's check collections. As a part of the service, the bank's employees pick up the checks, open the envelopes, record the payment information, and make deposits straight into the client's account. Obviously, from a cost-efficiency standpoint, this service is used primarily by businesses with a large volume of check-based receivables.

The enactment of the *Check 21* (Check Clearing for the 21st Century) law in October of 2004 brought to life drastic time reductions in check payment processing by utilizing imaging technology and allowing the substitution of physical paper with its digital equivalent cleared through the interbanking system electronically. No more trucking of checks across states lines!

Thus, *remote deposit capturing* (RDC) has become a reality. It has raised the efficiency of lockbox services to the next level for large-volume bank clients. It has also had a great impact on businesses with a much smaller inflow of check payments. Now any company can use online *remote deposit services* (RDSs) by attaching a little check-scanning device to a computer and logging into the RDS portal of your bank. Besides the obvious benefits of eliminating trips to the bank, the ability to make deposits 24/7, and the enjoyment of cutting down on clearance processes, there are additional privileges offered by financial institutions: extended hours for the same-day value (up to 10:00 p.m.), automatic payee endorsements, early notices for rejected items, and downloadable data.

Merchant Services

It's interesting that the name for these services is derived from the narrowest definition of the word *merchant* you can find in a dictionary: a store owner. Ever since retailers and food establishments started accepting credit card payments about 50 years ago, banks moved to become members of Visa and MasterCard associations and perform a merchant service that in the banking industry is called *acquiring* (i.e., collecting sales drafts and subsequently crediting the proprietors with the net proceeds).

■ **Note** This is not a chapter on the history or the mechanics of the credit card industry. Nevertheless, for the sake of clarification I would like to offer some additional information. Banks who become members of Visa and MasterCard associations can be the issuers of credit cards, or the acquirers (providers of the merchant services), or both. Other credit cards institutions—American Express, Discover, Diners Club, and JCB—are self-contained companies that don't utilize banks. They handle their own issuing, acquiring, managing of cardholder payments, and handling of disputes.

Merchant services have been associated with brick-and-mortar companies to such an extent that at the dawn of e-commerce, when Internet entrepreneurs looked for shopping cart solutions and naively called their banks, they were frequently met with requests to visit the retail locations.

The window of opportunity was opened, however, because the issuers/acquirers always outsourced the processing of plastic payments (authorization, capturing, settling) to third-party providers—Global Payment, First Data Resources, and so on. The Internet demand resulted in the creation of a new processing technology, *payment gateway*, which allowed entering any type of credit card information into a *virtual terminal* online. The largest provider of payment gateway in today's market is Authorize.net.

An ability to process online credit card payments opened the doors of merchant services to companies in industries that had nothing to do with retail. Their options further expanded with the development of service providers who combined virtual terminals with the conversion of information captured from *debit cards* or *checks* (also called *e-checks*) into *ACH debit requests*, drawing funds directly from the payers' accounts.

■ **Caution** There are so many payment-processing companies now that selecting the right one becomes a special project. The reputation and fee structure are the two most important areas of research. A good place to start is the TopTenReviews site: www.toptenreviews.com.

Things came full circle when banks realized that offering their clients a variety of possibilities to collect receivables is another value-added service. They had no choice but to enter this market sector. Chase Paymentech, for example, was listed at number 5 on the TopTenReviews' 2011 merchant service providers list. American Express OPEN has created its own set of cash management applications targeted toward small businesses. Since the basics are pretty much invariable, the competitive edge is gained primarily by moderation of fees and enhanced services such as recurring billing, electronic invoicing integrated with clients' systems, and reporting features.

There is pretty much no limit anymore on what type of companies can use merchant services now. Whether you are a law firm or a machinery manufacturer, you can offer your customers an opportunity to execute a payment online, further reducing the receivables turnover cycle.

Payables Solutions

I stressed in the last chapter that building your *payment reputation* is the key to negotiating better terms for the sake of improving the company's liquidity. When you consider the innovative payment options offered today by dif-

ferent financial institutions, that consideration should be the primary criteria. Of course, *labor-reduction convenience* is another concern. And you should also be aware of the options that let you legitimately gain more time on paying your bills without any detriment to your vendors and suppliers.

Electronic processing cut a huge chunk of time out of treasury tasks by getting rid of repetitive entries. We are able to set up templates for any form of payments: account transfers, ACHs, domestic and international wires, and letters of credit. All predefined fields are populated, leaving only variable items to be filled in. Even the examination of international trade documents presented for payments can be done electronically today.

Setting up recurring ACHs for periodic flat-fee payments eliminates the possibility of missing a payment or being late by accident. And, while giving authorization for automatic withdrawals somewhat diminishes your control over disbursements, it is perceived positively by vendors and can earn you some goodwill for future negotiations.

Business cards have always been good options for consolidating and keeping track of T&E (travel and entertainment) expenses in a single report. Card issuers try very hard to gain a competitive advantage by providing their customers with further improvements of delivery and integration of expense data. However, with many vendors offering online payments option now, business credit cards have become a useful liquidity management tool even for the companies with barely any T&E activities. They give you an opportunity to pay bills on time, while delaying the actual cash outlay by at least 30 days at no extra cost. One of the best business credit card offers today is the Plum Card from American Express. It provides you with 1.5% discount if you pay your bill within 10 days of the statement's closing date, or gives you 60 days to pay the full outstanding balance with no interest.

Foreign Currency Management

All major global banking conglomerates provide online foreign exchange portals to their international business customers with multiple-currency exposure. Regardless of the differences in user interface, they all offer direct access to foreign exchange transactions and a similar spectrum of services: you can check current and future exchange rates, buy spot contracts, hedge your deals with forward contracts, and book options to match your target rates. These online products are usually combined with the standard treasury management capabilities allowing the client to see activities on the accounts and execute international wire transfers in correspondent currencies.

Just as with stocks, bonds, or commodities, currency trading is an open market. Naturally, besides the banks' foreign exchange departments, there is a long list of brokers who perform exactly the same transactions and offer their clients similar services. Many of them are big enough to command great buying power and compete with behemoth bankers on the pricing. The ratings frequently shift, but FxPro and TradingPoint almost always appear on top-ten listings.

There is one undeniable liquidity advantage in doing your foreign exchange business with the same bank you have a credit line at. Since your credit has already been approved there, you don't need to pull funds away from operations to cover a margin deposit required by the brokerage houses as a security for forward contracts.

Payroll Management

Payroll, being one of the most significant outlays in many operations, is a big part of the cash management function. It is safe to say that many companies nowadays opt for outsourcing payroll to such third-party processors as ADP and Paychex. In fact, the only companies I know that still keep their payroll processing in house are the ones with severe cash flow problems—they desperately need those couple of days of check float advantage and prefer to pay tax authorities at the last possible moment. They cannot afford the processing simplicity of the payroll service provider that initiates each pay period just two ACHs out of the designated accounts: for tax payments and for direct deposits into employees' accounts. Besides the convenience of direct deposit, so cherished by employees, the most significant benefit of using payroll services lies in the time saved on the tax preparation, especially for multistate companies. That said, if your payroll taxation is limited to one state, a well-integrated payroll module, such as the ones offered by some ERP solutions and QuickBooks, may be sufficient.

Some entities go even further and use complete human resources management solutions provided by such companies as Triton LLC, covering the entire employment cycle: recruitment, time keeping, payroll processing, benefits management, termination, and post-employment. Triton specifically targets small and midsize companies with lean organizational structures, offering significant cost reductions by not only replacing entire departments and eliminating costly software implementations, but also by supplying benefits at much lower rates than a small company would be able to negotiate.

As I mentioned in the beginning of the chapter, there are numerous smaller, Internet-based providers offering a spectrum of cash management solutions,

such as merchant services, automatic payables disbursements, and “payroll processing.” It is tempting, especially for a small company with limited staff, to concentrate all these needs into one hub. Yet, you must be an educated consumer here: most of these companies can take care of the direct deposits, but they will not file your federal and state payroll tax returns or make the appropriate payments on your behalf. Another key issue here is the cost/value consideration. Keep in mind that these companies have their own cost structures and their pricing comes with a premium, even though they are able to negotiate wholesale rates for themselves. Just as with any service provider, take your time to shop around for the best pricing and the most efficient and comprehensive functionality.

Data Mining: Information Management, Analysis, and Reporting

Entrepreneurs and CFOs open the business sections of their daily newspapers every morning with a good chance of encountering the cliché that *information is power*, and it may make total sense to them in the context of the material they are reading. Yet, many of them fold the paper, come to the office, and try to run their companies with inadequate or nonexistent analysis of their enterprise's health. This is the functional area, where a CFO or controller can impact the commercial survival of the business in the most profound way. Quality and expediency of analytical and reporting activities are at the heart of executive decision-making, and have the power of promoting a success or instigating a failure. In the fast-paced environment of the present economy, providing essential information at the right moment is like supplying oxygen to a human brain—in its absence, you cease to exist.

Information Technology Decisions

For years I've been trying to come up with a snappy, aphoristic explanation of why so many CFOs and controllers have absorbed the responsibilities of the chief information officer. It's not easy because the underlying reasons are not that trivial, nor are they limited to smaller companies with flexible structures, fluid job descriptions, and frequently blurry lines in the division of responsibilities. Larger companies and even international conglomerates have experienced the same qualitative change.

There are, as always, unique explanations pertaining to individual entities, but it is possible to isolate a few general causes behind this functional blending:

- Historically, a large portion of data processing has been related to accounting and finance tasks, so CFOs have naturally been positioned as leaders of computerization movement.
- A substantial portion of analytical reporting has always been expressed in monetary terms, thus placing the responsibility for it into our hands.

- The perceived reliability and meticulous disposition of financial professionals make them obvious candidates for making decisions that may cost a lot of money but must create improvements in the company's performance.

Regardless of the etiology of this change, the fact remains that many CFOs and controllers are heavily involved in the information technology (IT) matters of their employers. For this reason, I felt compelled to start this part of the book, primarily devoted to data digestion and analytics, with a chapter on the responsibility many top financial managers are expected to add to their job descriptions: the selection of functional software. Without a doubt, we have a vested interest in making the best decisions we can within given constraints, because ultimately they influence our own ability to extract relevant data and compile a system of reports that will accurately reflect the business's current state of affairs. There is no question that successful data mining is dependent on a computer system's capabilities. So, why would we want anybody else choosing applications for us?

Software: Weighing Pros and Cons

If you are empowered with the authority to select, improve, or upgrade the technological and computing environment of your employer, keep in mind that this is a task that demands wearing many hats at once. You must optimize sometimes contradictory considerations, constantly keeping in check the desire to satisfy your departments' priorities first; plus you must fit the project into your own budgetary calculations. You want to be a strategic thinker. You want to be an agent of change that will propel your company into the future. You envision information seamlessly flowing from product design to financial statements. But can it be done with minimal capital investment? The strategic plans of business development must be weighed against the streamlining of operations, the integration of data against internal controls, customer service expediency against cost efficiency, and so forth. If it sounds like an impossibly difficult task, that's because it is.

It is a good idea to start by *making a list* of everything you may want from a system and prioritizing it in the order of importance for the entire organization. It should be as detailed as you can manage. I have seen so many companies making expensive IT choices based on someone's suggestion ("Oh, it's a great program. I love it!"), or because they liked the first presentation, or because they were impressed with the look and feel of a particular entry screen. The right thing to do is to think very hard about the expectations of every single user and every single information recipient. Whether the end

result will satisfy everyone is a different story (most likely, it will not). Nevertheless, that is the right way to start.

It is mandatory to discuss this wish list with your peers managing other functions, so that nothing goes missing from the list. None of us wants to meddle in the business of other VPs. They run their departments to the best of their abilities. On the other hand, this is necessary if you are to make decisions about informational support of their functions. No matter how busy your CEO is, you must assess his or her expectations as well. Then you can try to qualify different features of the packages under consideration against these various aims. The most important thing is to constantly perform a cost/benefit analysis, evaluating the gains you will achieve against the full cost of this difficult exercise.

As always, the wish list will vary from business to business. Yet, I find the following general considerations most relevant to the selection process, regardless of the company's operational specifics.

ERP vs. Special-Purpose Applications

As a holistic CFO who understands how all parts of a business are interconnected and affect each other, you must focus on finding a solution that satisfies the needs of all functions along the company's value chain and on creating a data flow with minimal gaps. Putting other aspects (such as cost concerns) aside purely on a technical level, this can be achieved in two ways:

- Through implementation of an enterprise resource planning (ERP) system
- By combining a program that covers the majority of general functions, particularly accounting, with specialized software designed for purposes particular to your industry

As attractive as the idea of completely integrating all business functions is, this does not mean it will satisfy your specific needs. If it fulfills all your requirements, you don't need to look any further. Yet, one has to remember that the best thing about an ERP system is its modular connectivity. When evaluated separately, the modules don't necessarily rise above a generic level, so the unique requirements of each business are usually accommodated through further customization, and still the users may never be fully satisfied. On the other hand, there are industry-specific solutions on the market that may completely match your operational or service needs. Such a perfect fit potentially outweighs the benefits of the complete integration offered by an ERP system.

Quality of the Accounting Modules

Even though the basic accounting functions are more standardized than operational ones, not all accounting modules are created equal. In some packages they make more logical sense than in others, while others are more user-friendly. For example, a package may have award-winning order-processing and inventory management modules, but if your company is in a service industry with monthly billing, such capabilities are irrelevant. Look instead for an application with a strong customer service module. I like Microsoft Dynamics SL very much, but think long and hard before acquiring it if you have an in-house payroll. The payroll module is this application's weakest link: it is not fully integrated with the general ledger and has no tax returns functionality. When looking at accounting modules, take your time reading the specs for all relevant tasks, and ask for exhaustive demos. Make sure that you are satisfied with their functional abilities.

Reporting Capability

The reporting capability of the software in your use is the foundation of the data management and analytical functions. It determines efficiency, expediency, and ease of manipulating data into anything from standard financial statements to a spur-of-the-moment study of a particular business parameter. Your wish list must include all variations of information you may need, and all possible presentation formats. It is important to completely understand the different levels of data utilization available to you. There is a big difference between a system's ability to produce listings of all purchase invoices by vendors, and the potential to analyze a particular product's procurement history broken down by country, state, supplier, and price range, even though they come from the same set of data. In the current technological environment, you may need to assess the following reporting facilities:

- *Predefined system-generated reports:* Nowadays more sophisticated packages have a limited number of preset reports—they give users freedom to design their own instead, so that, for example, cash flow statements can group data from different accounts exactly as you want. However, you should make sure that certain standard reports—such as orders, invoices, agings, statements, journals, and trial balances—satisfy your requirements. You don't want to spend time and money designing those. Also, if you cannot allocate time and talent resources to report tailoring, you should look for solutions with more comprehensive lists of system-generated statements.

- *Ease of data querying:* Business solutions are database driven. On a very simplistic level, this means that all information entered into the system is stored in tables: inventory item tables, sales invoice tables, and so forth. Every new record entered into the system becomes a row in the table, identified by a unique number (PO number, invoice number, etc.), with columns populated by field entries (customer's name, quantity shipped, unit price, etc.). This structure provides an opportunity to pull different combinations of data from a particular table based on specific criteria. For example, if you want to see all sales made to a particular customer, you can specify the customer name, and the system will look at all the records (lines in the sales table) with the matching "customer name" field. That's basic querying. However, some systems come with more user-friendly tools for querying than others. In many applications, the field names are converted into codes, and you have to use special linguistics to specify your selection criteria. Consequently, the user needs to figure out his way around it before being able to draw the simplest data query. If you need your less savvy junior or middle-level staff to be able to extract information whenever you need it, you should consider looking for applications with simpler querying functionality.
- *Drill-down features:* These are important in two forms: in live data displayed within the system, and in the reports generation. When you bring up a customer's account, you have the ability to click on an invoice and see its details, and to go from there into the sales order, the salesperson's history, and so forth, which is a very valuable intelligence tool. On the other hand, the report's drill-down features allow you to look at a summary linked to related data in other reports. For example, if you are looking at a sales control account in the trial balance, clicking on it can lead you to a sales journal composed of invoices, etc.
- *Data exportability:* Depending on the number of modules in your operating system, your business information may be stored in dozens, or even hundreds, of separate tables. If the analytical demands call for manipulation of the data beyond querying capabilities, or for presentation in a specific format (e.g., in PowerPoint), or for a combination of data from various tables (e.g., if you need to see all sales of a product bought from a particular supplier), you must be able to export information outside of the system—into Excel, Access, and so forth. Also, it is not just the ability to export; the different options for doing that are extremely important. Some systems limit

you to exporting information as a printed report with merged columns and repeated page headers, which results in a time-wasting reformatting process just to make the data workable. Others offer an option of throwing raw data into pure, unformatted arrangements, which is preferable.

- *Data warehousing*: If you can afford to go a step further in your ability to successfully manipulate data pulled together from different informational sources, you should consider the possibility of integrating your data into a *data warehouse*—a unified database specifically used for storage and reporting purposes across the entire business. Even if it is only a remote possibility for your company, you should consider your operating system’s ability to be linked to such functionality.
- *Integration with report writers*: Further expansion of reporting capabilities is available through integration with various business intelligence software: report writers, which allow users to create data connections and design various report layouts. Some of the most prominent packages with broad design options (such as IBM Cognos, SAP Business Objects, Microsoft SQL Analysis, FRx, and Crystal Reports) work with specific database layouts—an important factor to consider. These report designers are fairly sophisticated and require training and close familiarity with their structures for successful utilization. There are also a large number of smaller business intelligence packages that offer a set of predesigned informational outputs, such as dashboards and sales graphs, populated by the data from the operating system. If you are considering the enhanced business intelligence options, your choices will be determined by the selection of the main application.

■ **Caution** None of the numerous possible IT woes can compare to the problem of your boss’s expectations of the new system’s instant reporting potency. In the mind of an average business owner, that should be proportional to the amount of money spent. If you’ve spent around \$100,000, the system is expected to “print” a report with any combination of randomly chosen data. If you’ve spent around \$500,000, the system should project the profitability a year from now, and the answer is expected while he is on the phone with you. If you’ve spent over \$1,000,000, the system must initiate a daily call to the boss’s personal phone, reporting in a soothing voice yesterday’s net profit. The only way to prevent these illusions is to keep a constant dialog and present a realistic picture without going into long technical descriptions—not an easy task either.

Online Accessibility

The ability to access operating systems and business data remotely has become very important to companies with multiple facilities in different locations and offsite staff. If that's the case, you should look for solutions with online login portals or other network capabilities.

Price

The reality is that for many small businesses this is usually the most important consideration. But even if the company is not that concerned about doing things the cheapest way, it is important to understand the full cost of a system so there are no surprises afterward. Costs include the following:

- The basic cost of the system's modules
- Cost of implementation (installation, setups, etc.) provided by the vendor (licensed distributor) and billed on the basis of hourly rates. Theoretically it is possible to strike a flat-fee deal with the vendor, but vendors usually despise the very idea of it
- Cost of customizations also provided by the vendor
- Cost of customer support; usually an annual fee
- Cost of automatic upgrades; also frequently an annual fee

If you are considering any of the additional integration options for the purpose of business intelligence, you have to estimate their main and support costs as well.

Vendor Selection

Except for the mass-market programs that you can buy in any office or computer supplies store, business software is usually acquired from a licensed reseller staffed with certified application specialists. On the surface it does not seem all that important, but as with everything, it is important to shop around for a vendor with a good reputation. There are companies, who after making their decisions, go through three or more different authorized distributors due to dissatisfaction with implementation scheduling or an inability to understand the business's needs and deliver promised quality. Vendor assignment usually works on a geographical basis, so when you call the software developer, ask for a few names in your area, and then check for references and even try to visit other companies who have already gone through the process.

Cloud Technology and Software as a Service

Cloud technology is on-demand technology complex that includes any type of software you may need, along with your data stored securely offsite, accessed via the Internet, shared by employees in different locations, and paid for with a monthly subscription. This is what I call a 21st century virtual company dream. Individual applications ready for cloud technology are known as Software as a Service (SaaS). Many developers are joining in the movement and creating their own packages, from SAP (with its Business by Design service, which at the time of writing is \$149 per month per user) to Intuit (whose QuickBooks is \$12.95 per month, with no contract). These could be good solutions for start-ups (as long as their Internet connection is strong).

Popular Software Packages

Software packages are usually classified based on the size of the targeted client, which naturally corresponds both to their price level and complexity: tier I, midmarket, or entry level. However, because the business applications market undergoes so many shifts, mergers, acquisitions, expansions of capabilities, and other movements, it's difficult to clearly make these distinctions. Instead, I will highlight the most dominant brands.

Large Enterprise Solutions

Without getting into a long discussion of what constitutes a large enterprise, especially in terms of sales volume (it is really a matter of each specific industry sector), I will say that full-scale applications by companies such as SAP and Oracle should not be considered by any business with less than 1,000 employees, and even then only if it deals with vast amounts of data, looks for a full integration of all functions, and has an unlimited implementation budget.

These developers' main focus is on database management and server/client architecture, which acts as a foundation for ERP products that integrate customer relationship management, product lifecycle management, supply chain management, supplier relationship management, and other functions into one platform. Yet, in the last few years, both SAP and Oracle have created ERP solutions scaled toward small and midsize businesses. In particular, SAP Business One can be suitable for companies with less than 500 employees. With its 14 integrated modules, plus e-commerce and the Internet access options, it is considered one of the best on the market.

Microsoft Dynamics Solutions

Practically all independent midmarket software I have purchased, implemented, and worked with has been absorbed into the Microsoft Dynamics business solutions suite: Solomon has become Microsoft Dynamics SL, Great Plains has become Microsoft Dynamics GP, Navision Financials has become Microsoft Dynamics NAV, and Axapta has become Microsoft Dynamics AX. They were all very good systems with strong accounting modules and better than average data integrity, which made them attractive acquisition targets.

They are designed to accommodate different industries and together pretty much let Microsoft cover the entire spectrum—manufacturing, distribution, financial and professional services, retail, and public sector—and they are suitable to any company with annual sales between \$2 million and \$500 million. The most important thing they have in common is their unique scalability. The developers constantly create new modules, and you can combine them into a full-scope ERP solution or select only those needed to cover all your main accounting functions, without losing any functionality. It makes these packages attractive to companies with different budgetary constraints.

Because they are Microsoft products, they have the familiar interface of any Windows program. Moreover, the export/import functions are really a snap and can be performed in different formats. The applications are integrated with the Microsoft FRx report designer, featuring impressive drill-down capabilities, as well as Microsoft SQL Analysis. As new and improved Microsoft report-writing solutions come along, they will most likely be just as seamlessly integrated as their predecessors.

QuickBooks Pro

QuickBooks Pro is considered an entry-level accounting package that can satisfy the needs of most small businesses. It is by far the most popular accounting software on the market. There are no modules—it comes fully loaded with all basic features of AP, AR, HR, general ledger, and basic financial reporting. It will not satisfy industry-specific business needs and it will not provide you with sophisticated project or product costing, but if those needs are covered by specialized software while your accounting and finance processes are fairly streamlined, it will do the job until you outgrow it. And, as of now, no one can beat its price.

QuickBooks Pro literally requires no training and can be learned in under an hour. It has limited but user-friendly querying features, and while it doesn't allow you to design any reports, the drill-down capabilities of the predesigned

ones are very handy. You can export data from any report into Excel as well. The only separate add-on you need to buy is a payroll module, which is pretty good, and offers a rarely found multistate tax return feature.

Many smaller CPA companies prefer it, because it allows setup for multiple companies, and they can create mirror images of all their clients by simply importing the client databases (this should give you a hint as to how small those databases are). Moreover, it is produced by Intuit, which also develops ProSeries, the best professional tax software on the market. The data from QuickBooks can be directly uploaded into the tax software for corporate tax return preparation. However, with this software, controllers and auditors alike should be especially vigilant when it comes to internal controls; unfortunately, QuickBooks allows easy override of past transactions.

Final Considerations

Making IT decisions is a daunting task. Whether you are overhauling the company's entire information-processing setup, changing portions of it, or upgrading to higher versions, you are stepping on a long, time-consuming, laborious and expensive path. The decisions themselves are just the beginning. The implementation and transitional periods, tremendously difficult for everyone involved, still loom ahead. In the end, the entire company, from receptionist to CEO, must live with the outcome of your efforts. So, if you are in charge, be most thorough and conscientious. Each step should be well motivated and evaluated from all possible angles.

Before you finally give the project a green light, it is advisable to make a final presentation to everyone whose contribution you have solicited along the way, including your CEO. Emphasize the most crucial changes, highlighting the future benefits and their impact on the company's well-being; give realistic estimates of all costs and put forward a conservative timeline of deliverables. Most importantly, make sure that the results can live up to the promises you make.

Ode to Excel

Spreadsheets and I, we go back a long way; and I mean a long way—as far as DOS-driven Lotus 1-2-3 with its execution of one-key commands. I still remember most of them. Many high-tech historians attribute the revolutionary success of IBM PCs in the 1980s to this program. It was the first computer software ever to use television consumer advertising. Alas, it lost the battle of rows and columns to a far more superior, forever improving, and now world-dominating rival—Microsoft Excel. But that does not diminish the brilliant simplicity of Lotus’s product name: “1-2-3” signified the combination of three fundamental capabilities of these instruments:

- Calculable spreadsheets
- Data analysis
- Visual presentation

Excel fulfills all these needs and more (functions that seemed futuristic nearly 30 years ago) all at the same time. Today you can take an empty worksheet and make it into an accounting ledger table, a calculating tool with automatically updated values, a business form, a fancy-looking report, a formal financial statement, a functional database, or a colorful diagram. And it’s all dynamic—it can be changed automatically or manually at any time. The possibilities are virtually unlimited. It wouldn’t be a stretch to say that it is used for a variety of purposes by every single businessperson around the world and by scores of folks who have nothing to do with business, including elderly people keeping track of their doctor’s appointments and primary school children preparing their science fair reports.

A Big Calculator

Accountants have come a long way since using various types of abacuses for millennia. In its most basic, primary purpose, Excel is the ultimate achievement in the “counting frame” evolution: a very large, powerful, and sophisticated calculating device with a screen for data visualization to boot. Whether you want it to emulate an adding machine by typing a set of numbers into a column to get a total, or optimize parameters in various models of strategic business development, Excel’s workbooks will accommodate.

Excel’s latest versions come with a library of formulas and functions, which I informally divide into the *numeration* and *analytical* groups. Many of the numeration formulas can be found on a good scientific calculator, and using them accomplishes the most basic of Excel’s tasks: mathematical, trigonometric, financial, and statistical calculations. All of these formulas can be used in analytical tools created within a spreadsheet environment as well, but they fundamentally differ from text, logical, lookup, and reference formulas, which either do not use numbers at all or manipulate them in a diagnostic rather than numeric sense.

The ability to *link spreadsheets* by referring cells in one of them to particular cells in others eliminates the necessity of updating multiple reports when some parameters change. It also allows us to hide the cumbersome and visually confusing calculations of voluminous data behind the elegant summary report. I have always found spreadsheet linking very helpful, especially when it comes to the executive reporting: that’s all the boss needs to see—the easily digestible one page.

Database and Analytical Functionality

All the data-warehousing tools, report designers, and business intelligence programs I mentioned in the previous chapter are great testaments to the technological developments in computing. They are also evidence of how huge the databases of some big-time operations are, and of the amount of money these organizations are willing to pay to track their information. They are definitely not for small companies.

The good news is that within Excel, data is arranged as a grid of cells organized into rows and columns essentially making up a database. You can apply data operations and analytical functions to it: sorting, filtering, validation, grouping, ungrouping, subtotaling, consolidation, scenario management, and so on. You can also bring in data from external sources, most notably Microsoft Access databases, and still apply the same tools.

One of my favorite Excel data analysis tools is the *pivot table*, which is basically a summarizing instrument. Besides the fact that a pivot table automatically sorts, counts, and totals (or averages) the source data, it allows the user to structure various summaries by dragging and dropping fields, so that he can select which data to look at. Then the pivot table can perform *cross tabulation*, which sounds mysterious, but simply means that it will make summary calculations for the fields you picked.

Figure 22-1 illustrates such a pivot table exercise. On the left side of the spreadsheet is a partial section of Company N's February 2011 open order details. The full set of data in this spreadsheet consists of 658 records and over 10,000 data cells, organized by order number. The right section shows a pivot table that analyzes the details and provides a summary of physical (tons) and monetary value of total open orders for each product as of February 28, 2011.

Logical, text, lookup, and reference formulas and functions are also very powerful, especially if you learn how to combine them to achieve the best results. Lookup formulas in particular help with searching for data in spreadsheets with many rows and columns. For example, if in the same illustration I'd wanted to quickly see which product was ordered in PO number C10440, I would write the following formula:

```
=VLOOKUP("C10440",$A$3:$Q$660,3)
```

specifying first my criterion, then the areas of search, and then the number of the column where my target data can be found. The cell containing the formula would return the desired answer: TITANIUM DIOXIDE.

Of course, the size of the database matters. Excel will not be able to handle the humungous volumes generated by multi-billion-dollar enterprises. But small and even midsize companies may never accumulate enough information to justify data warehousing. There is no argument against the beauty of business intelligence software integrated with your operational system, providing automatic real-time feed of data. However, it is a luxury unaffordable to the majority of small business owners, who nevertheless suffer from a lack of performance awareness. They need to know what's going on in their business without spending money on expensive software, high-salaried analysts, or consultants who spend days upon days "studying the business," only to offer their own in-house solution for several thousands of dollars. For these businesspeople, as well as their CFOs and controllers, the ability to have several revelatory and consistent Excel tools could be a lifesaver.

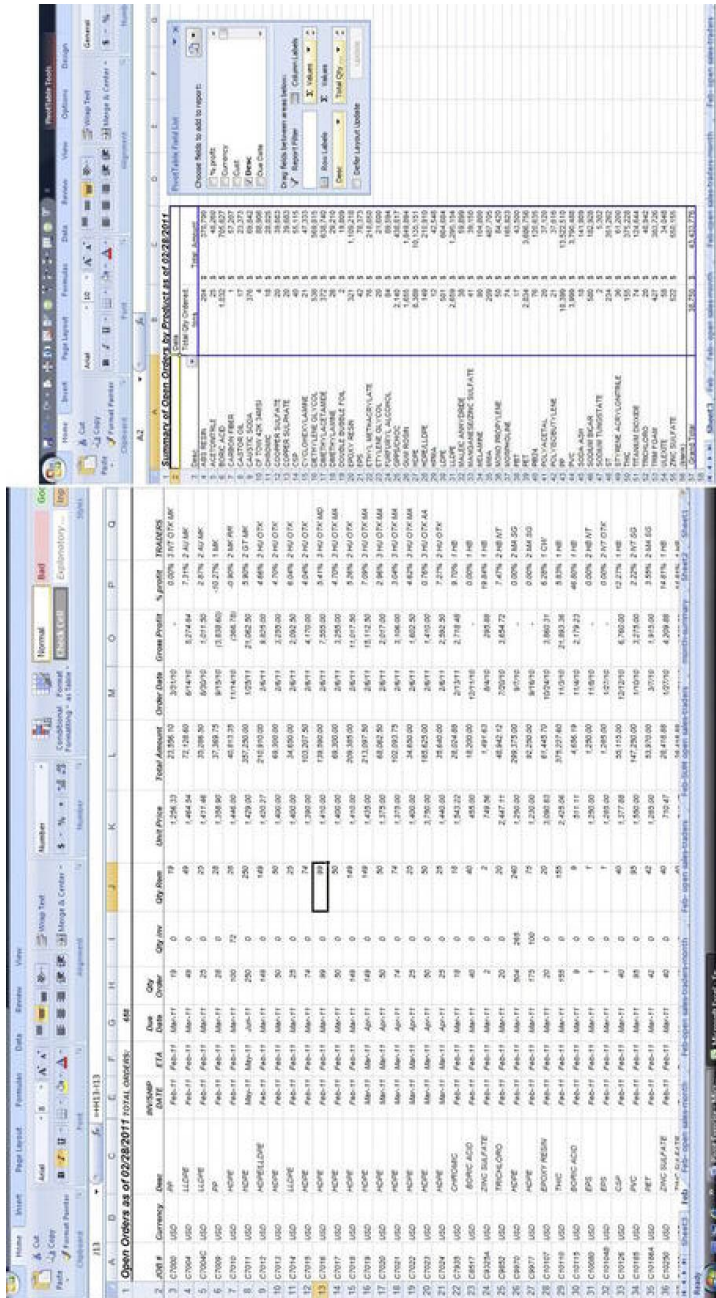


Figure 22-1. Pivot table functionality

Visualization Tools

The presentation of dynamic information in a form that makes logical sense, has visual appeal, and has the power of attracting the user's attention to the most important, most vital aspects of the message is one of Excel's biggest assets. Once in a while, it gives a CFO or controller an opportunity to convert the most boring set of data into an effective tool for influencing people's decisions and changing the course of their actions.

And it is not only about manipulation of colors, fonts, borders, and shapes. Excel also provides *conditional formatting* capabilities, which allow us to set rules for automatic changes to the data's appearance depending on the criteria we establish. I have to confess that the possibility of making a red flag pop up next to an item of concern makes dealing with the problem less aggravating to me.

Cognitive scientists established a long time ago that the human brain is better equipped to absorb information in visual formats such as graphs, charts, and diagrams than in the numerical or tabular formats. We cannot say yet that Excel has managed to incorporate all possibilities, but the options are expanding with every new version. I am particularly partial to the bubble chart, because it allows for the clear display of a three-dimensional set of parameters. Consider the one in the Figure 22-2, which shows the relationship between marketing expenses and sales volumes over the course of a year. Even without looking at the numbers, you can see that the larger sales bubbles are floating at the higher layers of marketing air.

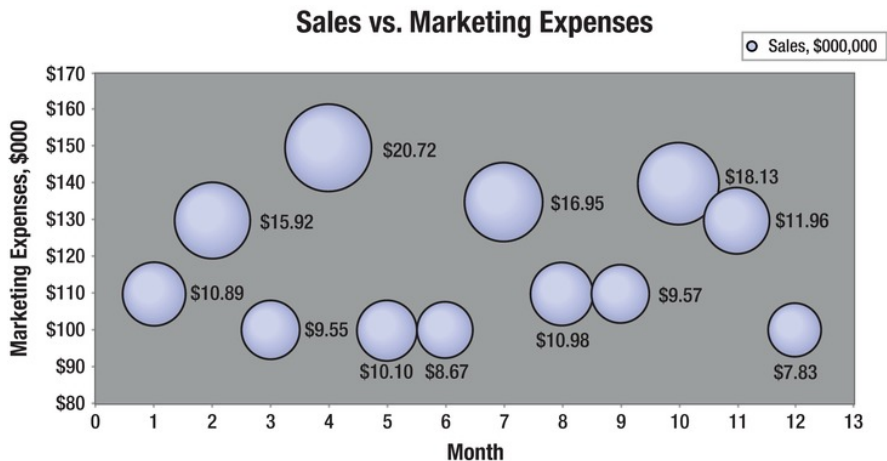


Figure 22-2. Example of an Excel bubble chart

The ability to combine different presentational forms within the same spreadsheet allows for the aggregation of different sets of data into dashboards, which will be discussed in the next chapter.

Integration and Beyond

Programmers always act so mysteriously because they are “coding like mad” with their secret languages. In Excel you can do that too—you can automate repetitive action by programming macros in Visual Basic. The spreadsheet presented in Figure 22-1, for example, uses a macro that separates the combined traders’ code in column Q into individual traders, allocates their profit contributions for each order, and creates separate trader-by-trader reports.

Another remarkable attribute of Microsoft Excel is that it’s a part of the Microsoft Office suite, which allows the interchange of data between different programs in the suite: Word, Access, Visio, PowerPoint, Publisher, and Outlook. The latest Excel version provides an ability to bring in data from outside resources via the Internet. For example, you can automatically poll external databases, measuring instruments (such as those from Bloomberg and Reuters), and commodities movements in accordance with a schedule of regular updates. It can also analyze results, update a dashboard, and make a Word report or a PowerPoint slide show. (I already mentioned in the previous chapter the ease of data inflow from Microsoft Dynamics ERP programs.)

Yet, that’s not all. The unique combination of powerful and diverse features combined with simplicity, acknowledged by millions of users, are obvious reasons why so many operational, accounting, and business intelligence programs developed by companies other than Microsoft create options for Excel-formatted outputs. For example, the popular IBM business intelligence package Cognos 8 BI has the Go! Office module, which allows you to work with Cognos content in Excel in order to “add value, apply calculations, use macros,” and enhance visualizations. Cognos Express Xcelerator, which was launched in 2009, is an Excel-based planning and business analysis tool targeted specifically toward the midsize market.

Some business intelligence theoreticians scorn analytical instruments created in Excel for being susceptible to each user’s whim. For example, if you create a report and save it in a public directory, someone can easily play with it and distort everything, with unknown consequences. However, today’s Excel provides opportunities to overcome such obstacles: you can restrict the document to reading rights only; you can share it on a document management server; and you can create a *document workplace*, for which you

can create a site for the workbook, appoint members, assign related tasks, and set the visibility of different documents and even separate objects within a workbook or individual spreadsheet.

No matter which parts and features of Excel you use, no matter the size of the business under your control, no matter which powerful computing and analytical tools you have available, you will almost certainly find something in Excel that you cannot get anywhere else. I have personally found Excel to be the most universal and comprehensive tool for many solutions and interactive analytical guidelines that I have developed for small businesses. I am sure we will continue using it until the next software revolution happens.

Executive Reports and Performance Analytics

Business intelligence and *performance analytics* are current buzzwords, but they are not new ideas. Those of us working with impatient entrepreneurs have been crafting just-in-time, sensible, easy-to-read executive reports for years. Our bosses would not tolerate obscure generic statements and schedules—they wanted reports that were creative, clear cut, and enlightened.

Having sufficient knowledge at your hands does not guarantee business success—there are definitely other factors, including economic and market conditions, competitive advantages, organizational adequacy, and technological changes, among many others. Moreover, some companies manage to temporarily ride the rising wave of their sectors and succeed without having any informational support at all. However, even under the most favorable conditions, being attuned to the company's health is a necessity of the long-term survival.

Theory of Executive Reporting

It's my professional trait: I've always considered timely, forward-looking executive reports to be a CFO or controller's highest priority. With every

new position or client, the first thing that I do is assess the managerial reporting systems' deficiencies. Then I study the possible needs of all key people, including myself, in the context of that particular business, and start improving existing tools and/or drafting new ones. This is very difficult, especially in small businesses, where mountains of other responsibilities are overwhelming. Yet there is no avoiding it, because the absence of good information is like sensory deprivation—without it, the business owners, our peers, and we are blind and helpless.

The scarcity of time is not even the toughest challenge. There is a reason I call it a reporting *system*—it takes a meticulous systematic approach to select the precise information that will have an impact on different business processes and facilitate successful decision-making; and then to determine the construction methodology, the scope, the timing, and the delivery. There are several fundamental notions behind this task that must be taken into consideration. First of all, executive business intelligence falls into two basic categories:

- *External data* collected and analyzed to assess market conditions, competitive benchmarking, economic factors relevant to this particular business, price movements of products and pivotal resources, and so on.
- *Performance reporting* on the company's own activities that provides valuable highlights targeted at specific executives in the context of their scope of interest within a certain time frame.

Secondly, when executive reports are constructed, a decision must be made for every piece of information on whether it is sufficient to deliver it as a *singular static figure* or in an *analytical form*. The latter can be any variation of time relativity, component breakdown, causal association, and so on.

Here are some examples that draw the distinction between these two types of information representation. You can have a commodity price ticker that shows an updated number every time you look at it, or a graph that displays the changes over time. A report can show the total number of employees participating in a company's profit-sharing plan, or it can show the departmental distribution of the participants. In a revenue report, data can be presented on its own, or in relation to the marketing expenses for the corresponding periods. Which representation you choose is an important decision, as it has a significant impact on how information is absorbed and utilized.

Thirdly, when it comes to performance reporting, I consider three types of information to be essential for executive business intelligence. I call them

results, *dynamics monitoring*, and *dynamics of results*. One can argue that everything that ever gets reported is a result. However, if we apply a strict logic to this concept, we can say that the *results of a company's performance* have a far more definitive and finalized connotation: distribution of sales, net revenue for the period, COGS, and profits cannot be determined until everything is confirmed, source data is processed and properly allocated, closing procedures are performed, and so on. On the other hand, any information reported continuously, drawn from immediate resources, without any formal digestive operations is what I call *dynamics monitoring*. It's like keeping our hands on the pulse of the business, assessing whether the vitals are OK, are better than expected, or require emergency attention. Finally, the analysis of the historical data provides us with the *dynamics of results*, allowing us to observe patterns, recognize trends, draw tactical conclusions, and develop strategies.

The descriptions themselves indicate that these definitions are closely associated with the reporting time frames. We cannot possibly report business "results" on daily basis—those are usually reported monthly. On the other hand, looking at sales broken up by day at the end of the month is meaningless—those numbers should be monitored in real time.

Considering the uniqueness of each business, it is impossible to come up with generalized recommendations. However, it can be safely suggested that the following items are crucial for daily dynamics monitoring by executive management:

- *Previous-day business activities*: These include market movements, the competition's actions, produced quantities, placed orders, booked billable hours, shipped quantities, returns, collected amounts, idle times, and whatever else applies, *broken down into different categories* (e.g., by division, region, product, or person).
- *Balances*: These include product and material inventories, cash, loans, unfulfilled business, and so forth.

If there are some intraperiod patterns or cycles, or daily attention is not mandatory, some of this data can be assembled into weekly or ten-day-period reports. On the other hand, such information as revenue breakdowns, compositions of COGS and overhead, profit analysis, budget variances, market share evaluations, and customers' acquisition definitely qualifies as performance results for monthly reports.

Reporting packages, regardless of their informational substance and timing, usually contain summaries (in whatever format was selected) and volumes of

detailed supporting schedules. It is not that obvious, but who sees what is an important functional decision. CFOs, controllers, and their analytical groups usually utilize all the data available to them for methodical scrutiny and deeper understanding of underlying reasons and causes. At the same time, it must be determined what level of detail is necessary to be presented to other users. Frequently, illustrative summaries are sufficient for CEOs.

■ **Tip** This is a small but nevertheless very important thing to remember when publishing periodic executive report packages: they always need to be time-stamped to establish continuity. Also, to prevent accidental alterations, never transmit the source data. If you must, you can convert it into a PDF file.

Key Performance Indicators

Key performance indicators (KPIs) have become a business jargon term that basically means a set of parameters that assesses a company's performance. These indicators don't necessarily need to be quantitative. They can be descriptive as well, aiming at organizational developments, structures, processes, managerial targets, and so on. However, in the context of this book, KPIs are metrics that reflect the achievement (or not) of a company's ultimate purpose: positive financial results. In fact, I consider KPI reports, regardless of their presentational formats, to be the best overall summaries in an executive reporting system.

That said, I've seen a lot of KPIs of different shapes and varieties, and I've found most of them absolutely irrelevant. A CEO looking at the 12-month revenue curve displaying an expected cyclical pattern does not learn anything new after spending a tidy sum for the ability to generate a graph at a push of a button—last year's curve had exactly the same shape. How does she know whether the business is doing better or worse now than a year ago?

The crux of compiling effective KPIs is finding items that for your particular business are the equivalents of human vitals you see on hospital monitors: what determines the company's blood pressure, pulse, heart rate, and so on. Revenue volumes and profits are always the most obvious financial indicators, but a capable CFO or controller thinks beyond that, looking for the factors that impact those final results. What made them happen? Was it the product mix, the geographical distribution, the concentration of labor?

When you know which information is most important for you and your CEO—which parameters affect your business’s ability to survive—then you can figure out what combination of data would have a real impact on decision-making, how frequently it needs to be seen, whether it needs to be dynamic or static, and so on. At the end of the day, it is all about common sense, and it is very specific. A hedge fund manager needs to see the ticker of his portfolio’s stocks and bonds all the time, and it is basically external data. On the other hand, any business that uses telemarketing, or some type of call center services, should consider such unique items as “cost per seat” (the full cost allocated to individual employee) to be one of the most important indicators, because the performance is evaluated on an individual basis.

The KPI example in Figure 23-1 is a compact but fairly elaborate report with a lot of vital information presented in an absorbable manner. This particular one happens to contain annual data, but it is usually produced on a monthly basis, showing the company’s progress throughout the year. Horizontally, it is divided into eight sections that represent the areas of executive interest.

Sales, gross profit, gross margin, operating expenses, and EBITDA are organized in identical fashion. The top row shows corresponding numbers from the previous year. The middle rows labeled with “0” show the target numbers for each of these categories. The other rows are filled with conditional formulas that analyze the actual results in the source data and place the numbers in a row that reflects their correlation with the target value: better by 10% or less, better by more than 10%, worse by 10% or less, or worse by more than 10%. This positioning of the results provides an instant visual performance assessment.

This example company deals in products with prices that fluctuate with the industry’s market conditions. That is why it is important to track the growth in terms of the physical units, free of the price effect, and that is why this data is displayed right under sales. The section displaying open orders projects future performance. The entity’s operations are fueled by significant credit lines, and one of the main concerns is the leverage covenant compliance imposed by the lenders. Accordingly, the bottom portion of the report addresses this area of interest. If the report is used as an interactive tool, rather than just reviewed as a printed summary, all numbers can be drilled down to the linked supporting data. It’s a comprehensive picture of the organization’s core accomplishments.

KEY INDICATORS, 2010	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2009	19,413,413	12,664,621	10,560,164	12,720,629	12,739,916	12,395,141	12,941,419	15,595,679	13,700,991	16,300,126	10,652,896	7,856,729	157,661,714
2010	18,064,016	19,025,750	-	18,732,789	19,895,864	17,421,576	-	17,190,445	-	16,094,083	16,006,488	17,553,194	197,785,879
SALES	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000	180,000,000
>+10%	-	-	-	-	-	-	-	-	-	-	-	-	-
+<10%	-	-	-	-	-	-	-	-	-	-	-	-	-
0	-	-	-	-	-	-	-	-	-	-	-	-	-
<-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
>-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
2010 SALES (TY)MT	16,146	10,822	8,300	10,767	10,529	10,596	12,742	14,850	13,249	14,069	9,957	6,813	137,140
2009	15,892	16,038	10,155	15,147	16,252	13,563	8,466	13,231	13,231	11,768	12,448	13,658	159,849
2010	244,601	273,637	155,748	87,033	305,295	326,689	261,257	463,297	415,203	683,138	223,846	276,546	3,748,551
2010	-	596,097	-	-	-	-	-	526,833	-	482,874	459,772	-	719,980
GROSS PROFIT	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	450,000	5,400,000
>+10%	-	-	-	-	-	-	-	-	-	-	-	-	-
+<10%	-	-	-	-	-	-	-	-	-	-	-	-	-
0	-	-	-	-	-	-	-	-	-	-	-	-	-
<-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
>-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
2009	1.20%	2.16%	1.47%	0.69%	2.62%	2.63%	2.02%	2.97%	3.03%	4.17%	2.10%	3.55%	2.39%
2010	-	3.13%	3.00%	3.00%	3.00%	3.00%	3.10%	3.06%	3.39%	-	-	4.10%	-
GROSS MARGIN %	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
<-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
>-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
2009	203,027	167,806	365,806	222,882	154,347	173,211	160,371	220,033	467,198	148,879	164,277	306,448	2,761,067
2010	-	264,486	251,395	263,975	-	287,113	268,957	267,459	271,382	338,573	276,277	381,335	3,280,179
OPERATING EXPENSES	250,000	250,000	250,000	250,000	250,000	250,000	250,000	265,000	265,000	265,000	265,000	265,000	3,075,000
>+10%	-	-	-	-	-	-	-	-	-	-	-	-	-
+<10%	-	-	-	-	-	-	-	-	-	-	-	-	-
0	-	-	-	-	-	-	-	-	-	-	-	-	-
<-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
>-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
2009	41,574	105,628	(210,650)	(135,169)	180,549	153,279	100,896	234,265	(61,995)	534,259	59,570	(27,902)	985,463
2010	-	331,611	-	-	-	290,374	-	250,374	21,512	-	-	338,645	-
EBITDA	200,000	200,000	200,000	200,000	200,000	200,000	200,000	185,000	185,000	185,000	185,000	185,000	2,325,000
>+10%	-	-	-	-	-	-	-	-	-	-	-	-	-
+<10%	-	-	-	-	-	-	-	-	-	-	-	-	-
0	-	-	-	-	-	-	-	-	-	-	-	-	-
<-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
>-10%	-	-	-	-	-	-	-	-	-	-	-	-	-
OPEN SALES ORDERS TOTAL	36,680,602	25,602,350	30,217,311	43,248,296	29,612,353	26,658,146	38,536,070	28,663,264	31,257,763	36,252,661	46,894,139	41,754,922	-
GP ON OPEN SALES ORDERS	1,592,133	1,088,274	1,087,944	1,485,988	980,941	1,156,413	1,445,158	1,172,378	1,086,347	1,446,661	1,801,459	1,756,090	-
SALES ORDERS NEXT MONTH	16,642,075	12,777,371	11,402,238	17,100,294	13,267,575	12,315,050	18,763,307	16,987,617	12,441,043	17,652,443	22,324,213	21,474,913	-
GP NEXT MONTH	812,688	561,202	388,242	661,843	287,021	637,440	777,567	737,104	524,558	716,979	810,256	845,619	-
2010 TOTAL LINE OF CREDIT UTILIZED AS OF END OF THE MONTHS	41,780,000	41,780,000	51,400,000	51,000,000	51,000,000	51,000,000	51,000,000	51,000,000	51,000,000	51,000,000	57,000,000	57,000,000	-
TOTAL LIABILITIES as of the end of the month	26,670,633	28,338,623	29,408,945	37,595,077	37,108,134	33,518,200	33,021,460	34,208,121	32,236,886	31,480,408	36,071,911	47,342,798	-
Leverage	25,092,663	26,392,490	26,804,453	34,084,874	31,967,402	36,037,377	32,903,180	36,307,481	30,432,653	30,014,508	38,214,388	40,969,087	-
as of the end of the month	6.27	7.10	6.70	8.52	7.99	9.01	8.23	9.08	7.61	7.25	9.32	9.99	-

Figure 23-1. Example of a KPI set

Dashboards and Other Visualization Concerns

The items of business intelligence and the results of performance analysis can be delivered in various formats, and dashboards have become somewhat of a fad. Technically speaking, a dashboard is an executive's interface with an information system, specifically designed to be easy to read. Just like a driver in the car—who does not need to know how the speedometer works, but can make adjustments according to his reading of the device—an executive should be able to quickly grasp the company's vitals presented to him. CFOs and CEOs need information integrated from different sources, they need it fast, and most of the time they need it in one place.

However, regardless of the look and feel, the success of a dashboard depends on the metrics that were chosen for monitoring. The form cannot obscure the substance. One cannot get carried away by beautiful visual arrangements. Gauges, for example, seem especially exciting to many executives. Indeed, they look awesome and justify the name “dashboard,” but they are the most difficult charts to read, they take up a lot of space, and they deliver information only on a single parameter. (They are definitely good for monitoring financial ratios, however.)

The point is that the executive reporting decisions discussed previously need to be made first and foremost. KPIs, balanced scorecards (primarily used in strategic planning and discussed in Part 8 of this book), and sales performance analysis are good candidates for dashboards. Accordingly, they can be efficiently designed only after the right performance parameter choices have been made. And truth be told, you don't need expensive software to create good reports. As I testified in the previous chapter, for small and midsize businesses, Excel can do just fine. All examples in this chapter were designed and updated in an Microsoft Office environment.

Keep in mind that since they are just visual representation of business intelligence data, dashboards can be real-time/daily, reflecting the dynamics of business goings-on, or weekly/monthly/annual, showing performance results and their dynamics over time. Even though most of them are created as a quick mental prompt for a decisive reaction, some can be used for a closer look and further analysis.

For example, the month-by-month performance numbers (sales, gross profit, gross margin, operating expenses, and EBITDA) of the KPI example in Figure 23-1 could be converted into graphical versions and represented by line or column charts one under another, making the example into a

dashboard. Used in this way, a dashboard is a great tool for someone who wants to analyze the actual numbers and see the correlation between different indicators. It allows a CFO or a controller to observe, for example, that when sales exceeded the targeted levels, in most months this was achieved by giving up a significant portion of profit margins.

The dashboard in Figure 23-2 is related to the same annual results for the same company, but I designed it specifically for a quick grasp of the most essential parameters. It does not call for detailed study of the actual numbers, but it provides a pretty clear picture of what happened throughout the year—a good instrument for a CEO. From the green columns of targets standing in the middle of sales and EBITDA charts, you can see that the company outperformed on sales most of the month, while opposite can be said about the bottom line. The line graph of the physical volume shows that the company sold more product in 2010 than in the previous year, regardless of the price fluctuation. The leverage gauge points to the unfortunate fact of the violation of the lender covenant at the end of the year. The numbers show that the company was in violation four times and only twice came within the established requirement. This is a clear indicator that the volume growth was achieved through heavier borrowing; maybe it is time to renegotiate the banks' conditions. To complement the sales and EBITDA presentations, the breakdowns of COGS and overhead are included. With material purchases being the largest outlay, the other cost components are taken out into the side pie to show further details.

For companies with primary concerns focused on what and who drives the revenue toward the desired targets, the dashboard presented in Figure 23-3 could be an acceptable visual solution. It analyzes the sales by geographical markets, products, and salespeople. It's applicable to any type of revenue: sales, collections, services, and professional fees. The version shown here is related to monthly results, but exactly the same concept can be adapted for the previous-day performance monitoring, making it a daily dashboard. The percentages on the breakdowns can be replaced by the dollar values; instead of open orders you can show, for example, market prices or estimated commissions.

December, 2010

KPI Dashboard

ABC, Inc.

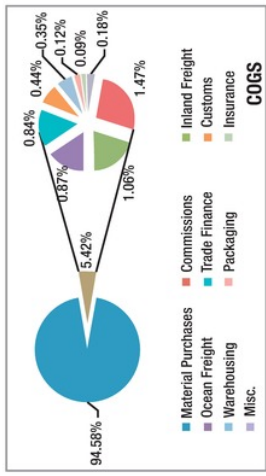
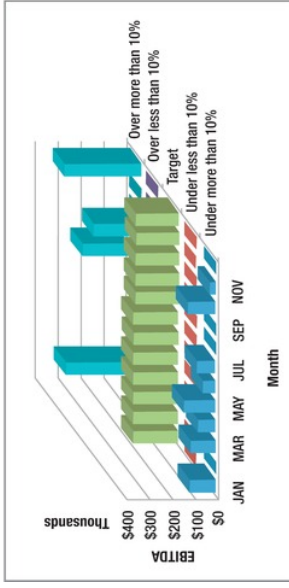
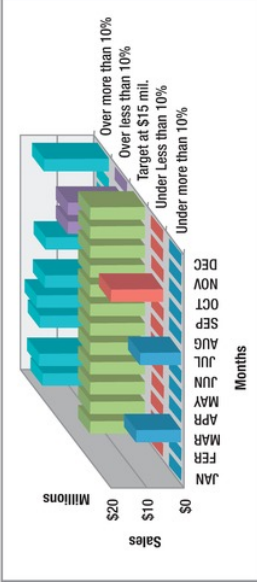
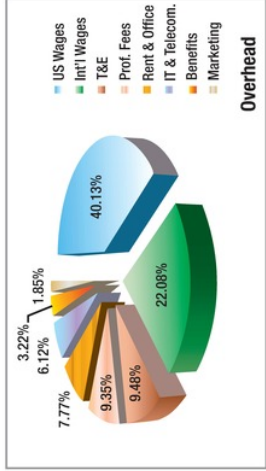
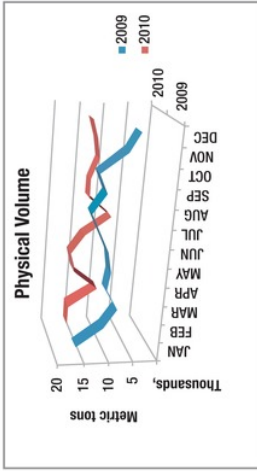


Figure 23-2. Example of a KPI dashboard

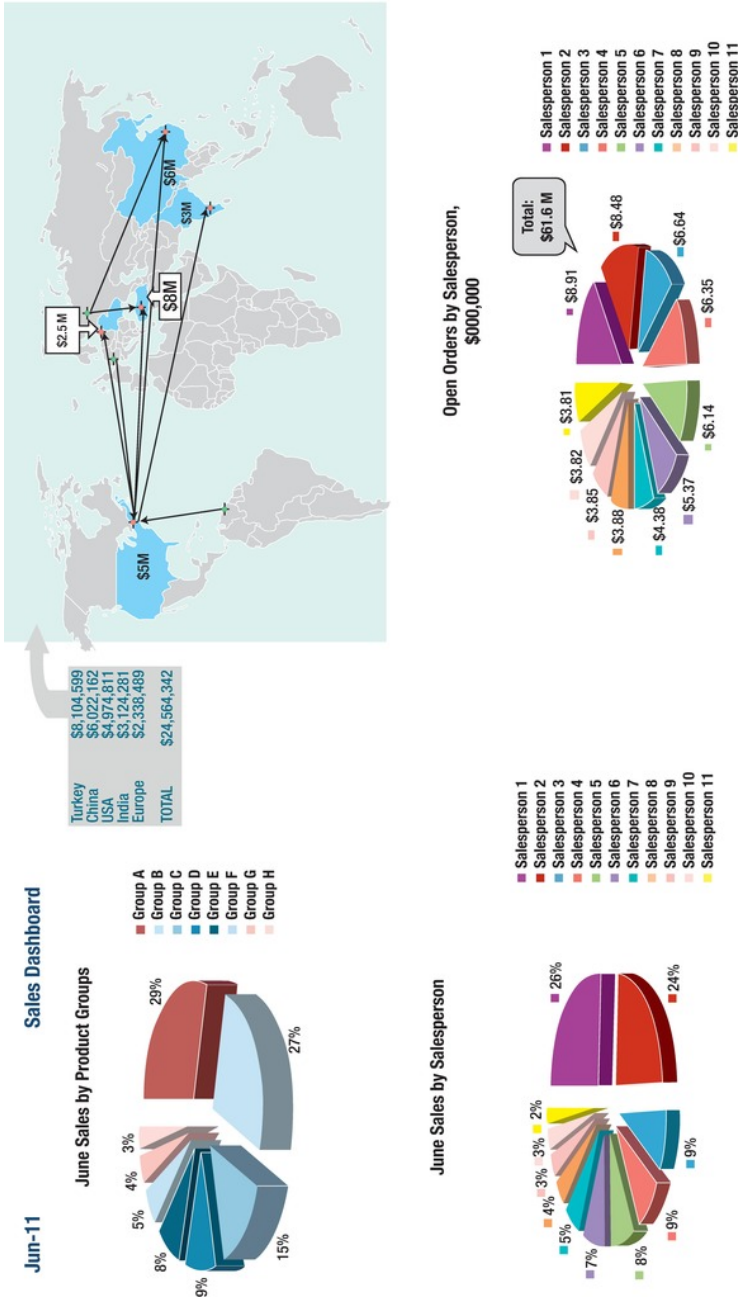


Figure 23-3. Example of a monthly sales dashboard

The visual variations are really unlimited, and I must reiterate that the design should be secondary to the data. As you can see, one of the biggest advantages of dashboards is the opportunity they provide to observe data from various sources within the same framework in an easily digestible format. If an executive needs to see the performance of all the company's divisions, they can be brought together onto the same screen. The job is to determine what will give her the best assessment of the situation and allow for making quick decisions.

Even if you have done your job well and picked the perfect information to be displayed in your dashboards, it can only be efficient if its visuals (tables, graphs, pictures, etc.) are updated automatically every time you open or refresh the files containing your reporting tools. Even if the perfect integration of the data inflow from the operating system cannot be achieved, many of the processes can be streamlined through linking of source data and macro shortcuts.

The big problem that I have with many purveyors of business intelligence and performance analytics solutions and software is that they seem to offer a certain set of tools designed to fit some universe of average cases. Standardization is mandatory in order to capture larger market shares. Businesspeople who buy these solutions end up spending a lot of money and then unnaturally trying to adapt their needs to the options they have, looking at pretty pictures without necessarily getting the help they need. I employ the reverse order: listening to users' concerns about the business, distilling the most important aspects of it, trying different versions, and only then devising a final analytical instrument. If you or your analytical staff are designing an executive reporting system, consider the ultimate users and include them in the preliminary process. Most importantly, keep the main purpose in sight—it must perpetuate the efficiency of the executive decision-making.

The Importance of Segmental Analysis

Most businesses are complex and comprised of various distinct operational sectors, or deal with different products or services, or conduct business in different regions. And that's an excellent thing—the more diversified the enterprise, the higher its chances for survival. I am a big proponent of various diversification strategies. However, when it comes to performance evaluation, diversification creates an additional important angle that cannot be overlooked.

You might have developed the most sophisticated executive reporting system that reflects overall performance, but if asked to pinpoint the exact segments, where you lose or make money, most likely the answer is too broad, or intuitive, or incorrect. Whether your company has the most sophisticated custom-designed ERP fitted with Cognos or makes do with a QuickBooks/Excel combo, the principal concept is the same: only segmental performance analysis can signal troubles in a particular business section. Practically all companies track their revenues by various categories, but this is not enough. *The purpose of segmental analysis is to determine each component's contribution to the company's bottom line—all the way to EBITDA is the best, but at the very least to the gross profit level.*

Segmental analysis is an important preventative tool that can show the first signs of developing problems, but it is absolutely mandatory in cases when the entire business organism shows signs of some illness and you need to identify the distressed areas. A few years ago, I was invited into a private company with national exposure—14 operational facilities in different states. Something was not going well in this business, which for several years had experienced stable growth coincident with the industry's rise. Its operating system produced all kinds of reports related to revenue volumes, but no one thought they needed anything beyond that. Now, all of a sudden, they started experiencing cash flow shortages, and they did not know why. The first thing I did was devise a profitability analysis for each of the locations. I uncovered that 9 out of 14 had been consistently bleeding money for the previous 18 months. I helped them to close 7 of them.

Principles of Segmental Analysis

CFOs and controllers instinctively know the parts that comprise the business—those cross-functional sectors that contribute directly to the bottom line. The most important principle to keep in mind is that structurally, *a segmental analysis is a profitability analysis*. Therefore, the subject matter concerns the *revenue-generating segments*. Every time executives ask about on-line sales of Software A, hours billed by the Chicago office, client contracts signed in Canada, and so forth, they're basically expressing their interest in the performance of a particular segment.

Then again, what is a reasonable level of detail? Do we need the Large Hadron Collider to break the business matter into invisible particles? Of course not, but a sensible division can give invaluable insight and bring about organizational changes. *The segmentation exercise is a game of optimizing a desirable level of detail with the resources required to achieve it.*

There are three natural *fragmentation categories* that, at the very least, provide a logical aid in defining the targets of the profitability analysis:

- *Organizational structure (which includes the geographical dispersal)*: This category includes, most obviously, locations (for businesses with multiple facilities, multistate and international offices, etc.), and also divisions, subdivisions, and so on.
- *Revenue generation composition*: This includes product lines (e.g., QuickBooks vs. ProSeries), types of products (e.g., computing hardware vs. consumer electronics), and services (e.g., auditing vs. consulting).

- *Profitability stimulants*: This category includes supply sources, market concentrations, distribution channels, and so on.

Of course, for some entities, the most rational partitions will not fit into any of these categories, and that is perfectly fine, as long as they serve their business intelligence purpose.

The *principle of allocation* applied to costs and expenses for the purpose of segmental analysis derives from the *activity-based costing (ABC) model*, in which all activities in an organization are identified and the cost of each activity is allocated to every segment. This includes all variable and fixed direct costs, as well as shared costs, overhead, and financing expenses.

For some businesses it may not even be necessary to go all the way down to EBITDA. Gross profit maybe sufficient if you have developed standards for acceptable gross margins. And if you break down your gross profit analysis to the salesperson level, it may open a window of opportunity for commercial control (which I addressed in Chapter 11).

In reverse, segmental analysis can be used to determine the *break-even revenues* for each sector, which are equal to the sum of all allocated costs. Break-even analysis on a segmental level can provide more insights into the operational adjustments and improvements that need to be made to achieve the desired profitability in a particular division (hire more revenue-generating staff while cutting the number of supervisors, replace some staff with technology, etc.). There are many ways of utilizing this knowledge, as long as sufficient diligence is applied to allocation of the expense components, which guarantees the accuracy of the calculations.

Segmental Chart of Accounts

A logical way of partially accommodating the efficiency of segmental analysis and making your life a little easier is to map your chart of accounts in such a way that it appropriates revenues and direct costs to the defined segments. Depending on the account nature, this can be done by setting up a separate general ledger account or through subaccounts.

For example, it is acceptable, to set up separate accounts for different types of revenues, if they are your segments, since you may want to identify them in different reports and even in the financial statements anyway. However, if the revenue is homogenous but is generated in different locations, then geographical subaccounts of a revenue account will do just fine.

Similar principles should be applied to direct costs, but I highly recommend considering each type separately. Materials used in manufacturing of various product lines can be separated into accounts. Operational payroll (e.g., professional staff in different national offices) can instead be divided into subaccounts. Sometimes the same expense can be treated differently depending on the circumstances. If you have one lease for a bunch of equipment used in different locations, it is better to allocate the parts of the lease, piece by piece of equipment, to subaccounts. On the other hand, if your different divisions handle their equipment leasing independently, the right thing to do is track that through separate general ledger accounts.

As I said, look at each direct expense category and make your decisions. The important thing is to segment whatever you can—then at least that part of the analysis can be covered by separate detailed reports drawn straight from your operating system. You will have your hands full with indirect expenses anyway.

Allocation Hurdles

The selection of proper principles of allocation for all shared costs is the most intense part of the analysis; and after you determine the principles, the allocation process itself is usually the most time consuming. If you have the financial and technological means to do so, have the defined allocation algorithms programmed and connected in your system to each category of expense, so that you can execute it every time you run the analysis. If the analysis is performed entirely in an Excel environment, you can replicate the same process by creating allocation schedules linked to your segmental report.

Many report designers opt for revenue volume as the most obvious and readily available basis of allocation, universally applying it to all expenses. However, even though the better-performing segments carry the biggest load of the company's expenses in general, for the purpose of analytical performance assessment, burdening them with higher shares may distort the results. This would be equivalent to punishing them for doing better than others, which is most likely the result of superior management and higher efficiency rather than utilization of more resources. I find the use of factors that create or drive the cost of an activity, known as *cost drivers*, to be an adequate foundation for the allocation methodology. For example, the most logical basis for allocating HR costs to a segment is a head count: the larger the operational staff, the more time and resources are spent on hiring, payroll processing, benefits management, and so on. If electricity is a shared

cost, the square footage occupied by each segment is a meaningful cost driver. For expensing the cost of operational software it could be man-hours, for equipment installation expenses it might be the time spent on the installation of each piece of equipment multiplied by the number of units in a segment, and so on. Revenue volume is an obvious cost driver for such categories as financing costs and payment-processing fees.

In the example presented in Figure 24-1, for instance, software and hardware leases, administrative salaries, and phones are allocated based on the head count of operational staff, because in this particular service company, it drives the number of software licenses, computers, administrative tasks, and volume of calls. On the other hand, merchant services, PayPal fees, and advertising expenses are directly related to the volume of services generated within each segment. The nature of the company's business is such that any direct contact between operational staff and customers creates the possibility of litigation. It leads to the necessity of keeping track of such contacts through operational software. This indicator is used for allocation of such categories of expenses as legal fees, liability, and malpractice insurance.

To Shut Down or Not to Shut Down

Let's say you have determined that one or more of your segments generate losses (such as location 4 in Figure 24-1). What is the decision to be made? Should it be closed (if it's a location) or discontinued (if it's a product or service line)? Should you get out of a particular region based on the fact of consistent losses? If it is a completely self-contained unit without any expenses shared with other sectors (e.g., USA Networks within the family of NBC Universal companies), the answer is obvious. Don't even delay it.

However, if the problematic segment carries a portion of the company's overhead on its shoulders, the best approach before you make the decision is to play the what-if game. What happens with the other segments? If you close this one, will they remain profitable? Will you need to make adjustments (e.g., lay off some general and administrative staff)? Does it make sense to keep this segment going so that it continues to carry the shared burden?

EFG, LLC					
Segmental Analysis (by location)					
	July 2011				
	Location 1	Location 2	Location 3	Location 4	OVERALL
REVENUE	328,985	798,102	237,801	293,086	1,657,974
Cost of Services					
Cost Group 1 - Professional Labor					
Operational Staff	80,640	155,520	69,120	100,800	406,080
Supervisors	9,167	21,667	7,500	13,250	51,583
Managers	6,667	21,667	6,667	15,000	50,000
Full Time Employment Expense	24,118	49,713	20,822	32,263	126,916
Subtotal: Professional Labor	120,592	248,567	104,108	161,313	634,579
Cost Group 2 - Professional Resources					
TU	3,032	9,313	4,981	4,332	21,658
LNA	2,200	2,200	2,200	2,200	8,800
CBI	2,400	2,400	2,400	2,400	9,600
PBA	4,958	11,296	5,893	3,118	25,265
Subtotal: Professional Resources	12,590	25,209	15,474	12,050	65,323
Cost Group 3 - Operational Technology					
Dialer	6,790	12,586	5,980	11,950	37,306
Operational Software Leases	4,844	9,688	4,219	6,250	25,000
Operational Hardware Leases	22,281	44,563	19,406	28,750	115,000
Subtotal: Operational Technology	33,915	66,836	29,605	46,950	177,306
Cost Group 4 - Payments Processing					
Merchant Services	3,755	9,110	2,715	3,346	18,926
PayPal	732	1,776	529	652	3,689
Subtotal: Payments Processing	4,487	10,886	3,244	3,998	22,615
TOTAL COST OF SERVICES	171,584	351,498	152,431	224,310	899,823
GROSS PROFIT	157,401	446,604	85,370	68,776	758,151
Gross Margin	47.84%	55.96%	35.90%	23.47%	45.73%
G & A Expenses					
Administrative Salaries					
Office Salaries	11,786	23,573	10,266	15,208	60,833
Full Time Employment Expense	2,947	5,893	2,566	3,802	15,208
Subtotal: Administrative Salaries	14,733	29,466	12,832	19,010	76,042
Rents, Utilities & Related Expenses					
Rent	11,000	21,167	12,667	17,667	62,500
Electricity & Heating	-	6,798	1,258	2,982	11,038
Other	308	1,292	-	275	1,875
Subtotal: Rents & Utilities	11,308	29,257	13,925	20,924	75,413
Telecommunications					
Phones	3,459	6,918	3,013	4,463	17,853
Internet	1,250	1,250	1,250	1,250	5,000
Subtotal: Telecommunication	4,709	8,168	4,263	5,713	22,853
Marketing					
E-mail Campaigns	1,000	2,000	500	1,000	4,500
Conventional Advertising	3,555	8,625	2,570	3,167	19,917
Search Engine Optimization	1,984	4,814	1,434	1,768	10,000
Subtotal: Marketing	6,539	15,438	4,504	5,935	32,417
Professional Fees					
Legal Fees	27,359	66,372	19,776	24,374	137,880
Accounting	7,937	19,255	5,737	7,071	40,000
Recruitment Fees	775	1,550	675	1,000	4,000
Subtotal: Professional Fees	36,071	87,176	26,188	32,444	181,880
Office Expense					
Office Supplies	654	1,308	570	844	3,376
Office Equipment Leases & Maintenance	450	1,250	450	750	2,900
T, M & E	1,368	3,320	989	1,219	6,896
Other Office Expenses	789	1,578	687	1,018	4,072
Subtotal: Office Expense	3,261	7,456	2,696	3,831	17,244
Insurance					
Corporate Umbrella	1,066	2,131	928	1,375	5,500
Malpractice & Crime	2,354	4,708	2,050	3,038	12,150
Subtotal: Insurance	3,420	6,839	2,978	4,413	17,650
Other					
Bank Operating Charges	1,526	3,702	1,103	1,359	7,690
Miscellaneous	234	469	204	303	1,210
Subtotal: Other	1,760	4,171	1,307	1,662	8,900
TOTAL OVERHEAD	81,802	187,971	68,693	93,932	432,398
EBITDA	75,599	258,633	16,677	(25,156)	325,753
	22.98%	32.41%	7.01%	-8.58%	19.65%

Figure 24- I. Segmental analysis by location for a service company

The scenario in Figure 24-2 shows location 4 closed. All direct and indirect expenses that fluctuate with the head count are gone now, together with the revenue this segment brought in. Yet the other segments' profitability and the overall bottom line have suffered significantly. The bottom line is \$63,000 less, and location 3 is now in the red. This happened because now the company carries an overhead burden that is too large for the reduced revenue. The starred expenses (hardware leases, administrative salaries, etc.) remain unchanged and have to be allocated to the surviving segments.

If the company could have proportionally scaled back the hardware leases, interrupted the space rental, and cut office salaries and marketing expenses by \$60,000 and \$50,000 a year respectively, it could have closed location 4 and still kept its monthly profits at \$325,000. However, it is quite rare that companies can get out of equipment or rental agreements easily; office layoffs may disrupt the normal course of business; marketing expenses most likely need to stay at the same level to make up for the lost revenue; and so on. Under these conditions, even the 9% loss in one segment is tolerable for the sake of spreading the overhead.

The rule of thumb is that as long as a segment can cover its direct expenses and shoulder some of the shared overhead, there is no reason to discontinue it. Work will need to be done to improve its performance and bring it out of the red zone, but it's still worth keeping. However, as soon as the segment's revenues fall below its direct expenses (or, even worse, its gross profit becomes negative), there is no reason to let it bleed better-performing sectors just for the sake of keeping it alive.

Unfortunately, we don't see too much awareness of a complete segmental analysis in either the corporate or consulting environments, and that includes business intelligence and performance analytics specialists. Based on my experience, segmental performance is one of the most deficient areas of business analysis. Everybody is busy breaking down revenues into a variety of combinations, but very few professionals go all the way to the bottom line. It is understandable—allocations are difficult. I know only a couple of consultants who consider segmental performance analysis their specialty and develop client-specific models for various businesses and industries at moderate rates. I strongly believe that it should be a central focus of multimodal small businesses—they cannot afford to let troubles in any part of their operations remain unnoticed and drag the entire company down.

EFG, LLC					
Segmental Analysis (by location)					
	July 2011				
	Location 1	Location 2	Location 3	Location 4	OVERALL
REVENUE	328,985	798,102	237,801		1,364,888
Cost of Services Sold					
Cost Group 1 - Professional Labor					
Operational Staff	80,640	155,520	69,120		305,280
Supervisors	9,167	21,667	7,500		38,333
Managers	6,667	21,667	6,667		35,000
Full Time Employment Expense	24,118	49,713	20,822		94,653
<i>Subtotal: Professional Labor</i>	<i>120,592</i>	<i>248,567</i>	<i>104,108</i>		<i>473,267</i>
Cost Group 2 - Professional Resources					
TU	3,032	9,313	4,981		17,326
LNA	2,200	2,200	2,200		6,600
CBI	2,400	2,400	2,400		7,200
PBA	4,958	11,296	5,893		22,147
<i>Subtotal: Professional Resources</i>	<i>12,590</i>	<i>25,209</i>	<i>15,474</i>		<i>53,273</i>
Cost Group 3 - Operational Technology					
Dialer	6,790	12,586	5,980		25,356
Operational Software Leases	4,844	9,688	4,219		18,750
Operational Hardware Leases	29,708	59,417	25,875		115,000 *
<i>Subtotal: Operational Technology</i>	<i>41,342</i>	<i>81,690</i>	<i>36,074</i>		<i>159,106</i>
Cost Group 4 - Payments Processing					
Merchant Services	4,562	11,067	3,297		18,926
PayPal	889	2,157	643		3,689
<i>Subtotal: Payments Processing</i>	<i>5,451</i>	<i>13,224</i>	<i>3,940</i>		<i>22,615</i>
TOTAL COST OF SERVICES SOLD	179,975	368,690	159,597		708,261
GROSS PROFIT	149,010	429,412	78,204		656,627
<i>Gross Margin</i>	<i>45.29%</i>	<i>53.80%</i>	<i>32.89%</i>		<i>48.11%</i>
G & A Expenses					
Administrative Salaries					
Office Salaries	15,715	31,431	13,688		60,833 *
Full Time Employment Expense	3,929	7,858	3,422		15,208 *
<i>Subtotal: Administrative Salaries</i>	<i>19,644</i>	<i>39,288</i>	<i>17,109</i>		<i>76,042</i>
Rents, Utilities & Related Expenses					
Rent	16,889	27,056	18,556		62,500 *
Electricity & Heating	-	6,798	1,258		8,056
Other	308	1,292	-		1,600
<i>Subtotal: Rents & Utilities</i>	<i>17,197</i>	<i>35,146</i>	<i>19,814</i>		<i>72,156</i>
Telecommunications					
Phones	3,459	6,918	3,013		13,390
Internet	1,250	1,250	1,250		3,750
<i>Subtotal: Telecommunication</i>	<i>4,709</i>	<i>8,168</i>	<i>4,263</i>		<i>17,140</i>
Marketing					
E-mail Campaigns	1,000	2,000	500		3,500
Conventional Advertising	4,319	10,477	3,122		17,917 *
Search Engine Optimization	2,410	5,847	1,742		10,000 *
<i>Subtotal: Marketing</i>	<i>7,729</i>	<i>18,324</i>	<i>5,364</i>		<i>31,417</i>
Professional Fees					
Legal Fees	27,359	66,371	19,776		113,506
Accounting	9,641	23,390	6,969		40,000 *
Recruitment Fees	775	1,550	675		3,000
<i>Subtotal: Professional Fees</i>	<i>37,775</i>	<i>91,311</i>	<i>27,420</i>		<i>156,506</i>
Office Expense					
Office Supplies	654	1,308	570		2,532
Office Equipment Leases & Maintenance	700	1,500	700		2,900 *
T, M & E	1,662	4,032	1,201		6,896 *
Other Office Expenses	1,052	2,104	916		4,072
<i>Subtotal: Office Expense</i>	<i>4,068</i>	<i>8,944</i>	<i>3,387</i>		<i>16,400</i>
Insurance					
Corporate Umbrella	1,421	2,842	1,238		5,500
Malpractice & Crime	3,139	6,278	2,734		12,150
<i>Subtotal: Insurance</i>	<i>4,560</i>	<i>9,119</i>	<i>3,971</i>		<i>17,650</i>
Other					
Bank Operating Charges	1,526	3,702	1,103		6,331
Miscellaneous	234	469	204		907
<i>Subtotal: Other</i>	<i>1,760</i>	<i>4,171</i>	<i>1,307</i>		<i>7,238</i>
TOTAL OVERHEAD	97,442	214,471	82,635		394,548
EBITDA	51,568	214,941	(4,431)		262,078
	15.67 %	26.93 %	-1.86 %		19.20 %

Figure 24-2. What-if scenario of the segmental analysis

Ad Hoc Reporting

As a head of finance and someone who is perceived to be the hard hat-wearing foreman of the data mine with access to the information ore, a CFO or a controller should always be ready for a spur-of-the-moment request to provide a peculiar set of data or an unusual analysis. Frequently, such inquiries come from owners/CEOs, whose business development plans or desire to look at the company's activities in a new light bring about special ideas. Other departments in your company may have urges for obscure combinations of numbers as well. Plus, there are various external parties for whom your must spin facts with the most radiant confidence. And on many occasions, creative and responsible financial executives themselves cannot stop their minds from digging deeper in the pursuit of the business's well-being.

Dictionaries give a definition for *ad hoc* as something formed, arranged, or done for a particular purpose only. This implies that such reports are usually used once, but it also has a connotation of an unpredictable relevance. Ad hoc reports may pertain to any part of a company's activity, deal with random combinations of data, and take a variety of shapes and forms. As disparate as ad hoc reports may be, there are few distinct features that apply to them all:

- They are usually sprung on you (whether by others or by yourself) without warning.
- They have no structural precedence, and therefore need to be conceived from scratch.
- They are always needed yesterday.

This urgency is always the biggest constraint on the reports' quality and ultimate value. It needs to be countered by *habitual preparedness and flexibility*. A financial leader should possess certain key attributes that guarantee an ability to mobilize informational and analytical resources on a moment's notice:

- An ability to quickly conceptualize the general reporting structure.
- An intimate knowledge of the data arsenal. You should completely understand the quality of the information, its potential, and what you can distill from it.
- Thorough knowledge of your accounting, operational, special-purpose, and general software. You must have full grasp on where the needed information resides, how it will be obtained, and what further analytical and presentational transformation, if any, it should undergo before becoming the final report.
- An acceptable level of flexibility. Not only should you be prepared for the request's essence to be altered at any given moment, but as the report's concept is being shaped, you should also be aware that unexpected ideas can come up. You should be ready to discard an inferior solution for the sake of a better one.
- Realistic assessment of your staff's abilities with respect to mining and analyzing the data as well as designing the report's structure and presenting the results in a sensible and effective format.

Following is probably the most important piece of advice I can give you about reporting functions in general, but especially concerning ad hoc tools. You may have experienced this situation firsthand. You receive a request for information in the following form: "Can I see numbers about [insert subject here] broken down into columns X, Y, Z (or rows 1, 2, 3)?" *Never accept this type of request.* The person asking most likely does not know what should go into columns and what should go into rows. Moreover, he or she may have only a vague idea whether the information requested will even answer the question at hand. My reply to such an inquiry is always the same: "Tell me your goals, and let me decide what information and in what form will fulfill your needs." *You must know the ultimate purpose of the data request.* Otherwise, you risk wasting time and effort without achieving any viable results.

By the same token, if you give an assignment to subordinates who are capable of making their own design decisions, don't demean their achievements by talking about columns and rows. Instead, also give them the reason for the report and then limit your involvement to general concepts and ideas—there are other pressing tasks on your desk anyway. That said, if you don't

have anyone on your staff who can complete this task on her own, the next level of involvement would be designing the report yourself and compiling instructions on how to draw the required data into it. Then you can pass it on for completion. Of course, in small businesses many CFOs and controllers end up doing all of it themselves—sometimes because there is no other choice, and sometimes because that’s the fastest way to go. I’ve done that many times as well. But if there is someone with a potential to grow, give them a chance. It will pay off in the long run, because there will be more ad hoc reports coming your way.

With a strong foundation of high proficiency and alertness, you and your analysts can design solutions to fill any informational void and satisfy any knowledge request. The following two examples show how different in origin, purpose, complexity, outcome, and effect ad hoc reports can be.

Due diligence processes conducted by prospective lenders and investors frequently give rise to ad hoc reporting needs. Outsiders have their own perspective on how the company’s performance and collateral value must be evaluated. For example, Figure 25-1 shows an analysis of 18-month inventory (a part of the collateral) dynamics requested by a bank. The company’s management never looks at such breakdowns of month-end balances, because the shifts between the selected categories occur not just daily, but many times during a given day. Yet the bank was interested in looking at the still snapshot, with balance sheet values of inventories divided by location and trading status, and further elaboration of the unsold position’s purpose. This report was prepared specifically for this objective.

Month	Month-end Inventory	Location Status		Trading Status		Unsold Position Purpose	
		W/house	In-Transit	Pre-sold	Unsold	Just-in-Time Needs	Anticipatory Pruchases
Jan-10	5,480,170	623,197	4,856,973	1,055,236	4,424,934	2,062,786	2,382,149
Feb-10	6,958,875	865,072	6,093,802	1,112,869	5,846,006	3,541,856	2,304,150
Mar-10	4,134,796	106,578	4,028,218	1,451,229	2,683,567	939,155	1,744,413
Apr-10	2,916,951	388,234	2,528,718	885,738	2,031,213	1,399,963	631,250
May-10	3,803,665	445,139	3,358,526	1,484,241	2,319,424	1,475,158	844,266
Jun-10	4,921,796	387,236	4,534,559	2,279,049	2,642,747	2,642,747	-
Jul-10	8,051,050	523,219	7,527,831	4,410,192	3,640,858	833,768	2,807,090
Aug-10	7,936,706	718,530	7,218,176	1,728,228	6,208,478	1,696,298	4,512,180
Sep-10	6,728,538	862,447	5,866,092	1,727,707	5,000,831	1,354,068	3,646,763
Oct-10	5,704,093	1,001,242	4,702,851	2,041,851	3,662,242	1,899,178	1,763,064
Nov-10	3,886,068	594,448	3,291,620	2,258,450	1,627,618	1,322,313	305,305
Dec-10	7,162,793	449,227	6,713,566	2,801,913	4,360,880	1,049,070	3,311,810
Jan-11	4,492,567	1,401,966	3,090,600	1,537,562	2,955,005	1,250,355	1,704,650
Feb-11	9,134,769	340,308	8,794,461	3,456,059	5,678,711	1,559,961	4,118,749
Mar-11	7,911,311	986,019	6,925,291	1,608,664	6,302,647	1,019,163	5,283,484
Apr-11	9,521,958	703,794	8,818,165	5,332,136	4,189,823	1,294,701	2,895,122
May-11	5,707,494	593,145	5,114,348	3,048,564	2,658,930	825,740	1,833,190
Jun-11	3,558,968	1,387,980	2,170,987	2,122,792	1,436,176	857,951	578,225
Average	6,000,698	687,655	5,313,044	2,241,249	3,759,449	1,501,346	2,258,103
% of Total Inventory		11%	89%	37%	63%	25%	38%
% of Unsold Inventory						40%	60%

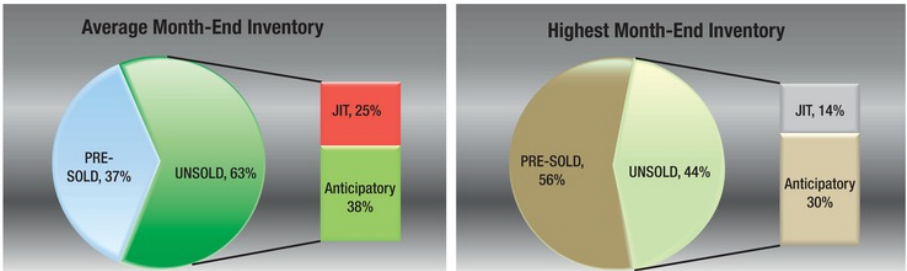


Figure 25-1. Ad hoc inventory dynamics report (courtesy of E&D CC)

The ad hoc study presented in Figure 25-2 has a completely different history. The idea for it came to me on a political hunch. For some time I'd been observing management changes that took place within several divisions of producer B, a European conglomerate and one of my then employer's top ten suppliers of various products used in different markets. Our overall purchase volumes seemed to be unchanged, but a few personal meetings with my direct contacts there raised my concern about the new management's tactics with respect to one particular product we used exclusively in the United States.

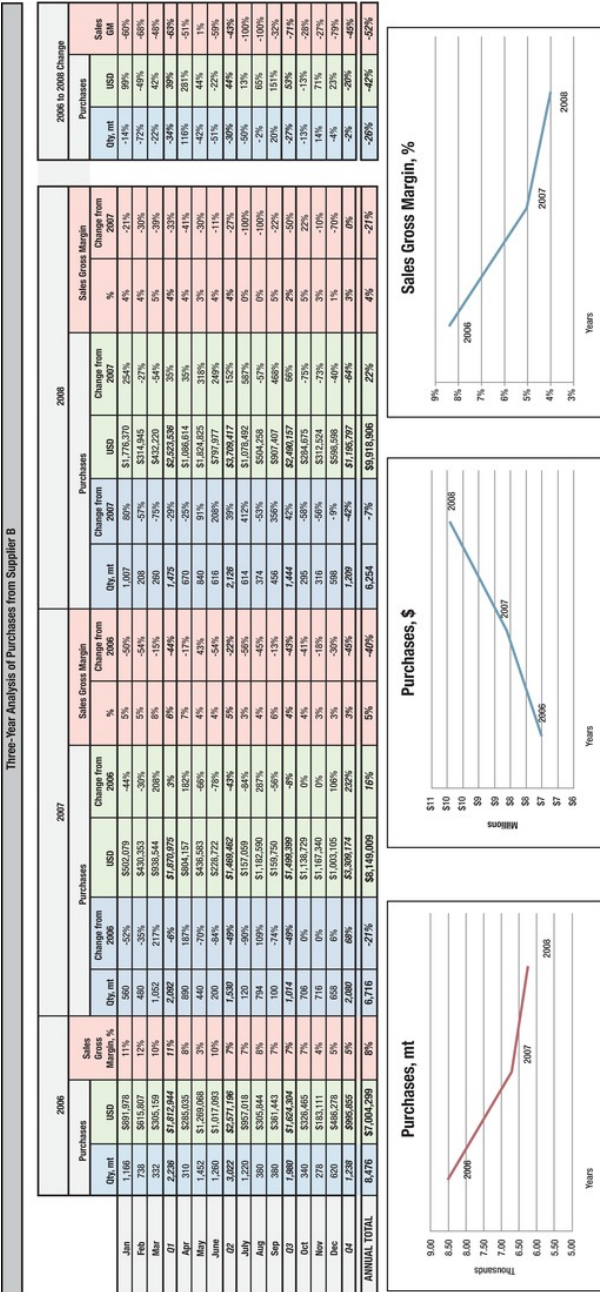


Figure 25-2. Ad hoc three-year supplier analysis

The CEO/CFO periodic reporting package I designed for my boss and myself included an assortment of segmental reports. My analyst dissected monthly performance by product groups, suppliers, and market sectors. However, since we bought different products from producer B and the material in question was procured simultaneously from different suppliers, my regular business intelligence did not provide me with sufficient information to confirm my suspicions.

I decided to isolate the purchases and sales of that product that originated exclusively from that supplier, and combine the analysis of physical and monetary purchase volumes with sales profitability over a three-year period. Unrecognizable on a short-term basis, a deliberate trend emerged: they were selling us less and less product (26% physical volume reduction) at consistently increasing prices (42% dollar volume increase), which resulted in the contraction of the related profits (52% reduction of gross margin). Since the material was in the top tier of the company's resources, eventually it would have a more significant impact on the overall performance. Armed with this knowledge, though, we were able to take care of the problem before that happened. In fact, this ad hoc analysis was transformed into a regular quarterly exercise applied to a group of products selected based on my specific criteria: if any volume of a top-ten product was acquired from a top-ten supplier, the concentration of exposure justified the task.

There is always the latent possibility of an ad hoc report turning out to be so important that it ends up on the permanent roster of periodic reports. I've seen sparks of fear in the eyes of many an analyst in this regard: "I'll do it well, and then they will want it all the time—more work for me." Sometimes I wonder if the relative sloppiness of some of the impromptu reports I receive is a manifestation of that subconscious resistance, rather than the result of the time pressure. I must say that's a terrible attitude. We all should take pride in the quality of our work, especially when it comes to business intelligence and performance analytics tasks, where we can create a real impact on business vitality. If you create something that makes a difference and is valuable enough to become permanent, cherish your accomplishment.

Accounting by the Book

This is not a part in which I try to jam the entirety of accounting theory and its practical application into a few chapters. It would be an impossible and, most importantly, unnecessary task. Even the owner of the smallest business needs the support of a knowledgeable accountant, and the readers who have reached the top levels of accounting and finance management wouldn't have been able to do so without knowing their way around their company's books. It therefore makes more sense to concentrate on several important elements that strongly affect the quality of conventional accounting's final products—the financial statements. Yet these items are, according to my observations, frequently overlooked, ignored, or forgotten. Standardized accounting principles used in preparation of the financial statements make these documents universally acceptable as a company's credentials to lenders, investors, commercial partners, licensing agencies, and governments. So, it is important that the books are compliant and the statements reflect the company's position accurately. Even if the books aren't being audited by an independent accounting firm, they should still be timely and correct—business conditions constantly change, and the need to present financial statements to an external party may emerge unexpectedly.

Clean Books and Compliant Statements

Everything that happens in the course of business activities must be reflected in the company's accounts so that it can be summarized, and at the end of a period presented in the form of standard financial statements: *balance sheets*, *profit and loss statements*, *statements of changes in equity*, and *cash flow statements*. Even events that cannot be quantified but have sufficient significance must be disclosed in the footnotes. Therefore, identifying accounting events and properly translating them into recordable transactions in accordance with generally accepted accounting principles (GAAP) are the core requirements for keeping orderly books and producing compliant financial statements.

Many corporate accountants, even at the CFO/controller level, seem somewhat insulated by their operating software from the necessity of delving into accounting theories. However, most accounting modules in their out-of-the-box state are equipped with capabilities common to everyone. It's impressive, but very general: they hide away the double-bookkeeping, making a typical transaction into a single-document entry; they can correlate inventory, receivables, payables, payroll, and fixed assets with general ledger; they

can aggregate subcategories, and so on. Yet they are not familiar with the specifics of your business: what constitutes your revenue, when that revenue needs to be recognized or deferred, what you can expense and what you must capitalize, how to interpret a financing transaction—the list goes on and on.

It is up to you and your staff to teach the system to do these things correctly, and to set it up so that the books reflect the business adequately. To accomplish that you must have broad knowledge of accounting concepts and a keen understanding of their applications. You also need to keep an eye on new developments and pronouncements issued by the Financial Accounting Standards Board (FASB) that may be applicable to your company. As with many things, it all comes down to combining your fundamental knowledge with new improvements as they come along.

The Fundamentals

The beauty of basic accounting principles lies in their universality. They can be applied to the recording of any transaction in any business. They are like a panacea: if in doubt, you can always turn to them to remedy the confusion. A real accountant, whose expertise is built on a strong theoretical basis and thorough understanding of the fundamentals, does not care about industrial specifics; his knowledge can be easily adapted. Actually, all new standards and practices developed by accounting theoreticians are deeply rooted in these time-proven canons and essentially represent their practical interpretations in light of particular circumstances.

There are ten commonly recognized basic accounting principles. I have seen them listed in different orders depending on the source. Most of them are extremely straightforward and ingrained in our professional consciousness to such an extent that we follow them automatically. Others are more complicated, and if misinterpreted can render books and financial statements incorrect. So, my list with brief comments itemizes them in the order of progressive importance:

1. *Economic entity*: This refers to the separation of a business entity from its owners.
2. *Monetary unit*: For the purposes of financial statements, we disregard the changes in money's purchasing power due to inflation.
3. *Time period*: We look at financial events that have occurred within a specified time period and at the results as of the end of the period.

4. *Full disclosure*: Whatever information is considered useful to the users of financial statements must be either reflected in the numbers or disclosed in the footnotes.
5. *Historical cost*: For accounting purposes we stick to the original costs, whether they are from yesterday or 100 years old. Therefore, if you want to know the current value of a museum's holdings, don't look at the balance sheet.
6. *Materiality*: If the amounts are relatively negligible, it is acceptable to violate guiding principles, rules, and regulations, as they will not have a significant impact on the financial statements.
7. *Going concern*: It is assumed that the entity will continue to exist long enough to accomplish its purpose and fulfill its obligations. This principle is the basis of *deferrals*; it allows us to allocate revenues and expenses to future periods, where they belong.
8. *Conservatism*: Already defined in the discussion of cash flow projections (Chapter 17) as an expect-the-worst principle, this dictates that we must value assets and incomes at the lowest possible levels, and liabilities and costs at the highest; and to anticipate losses, but never gains.
9. *Recognition*: The majority of businesses employ the *accrual basis* of accounting (as opposed to the *cash basis*), recognizing revenues and expenses, financing, capital, and all other transactions at the moment an *accounting event* (a sale, service performance, purchase, acquisition, etc.) takes place. Recording of credit sales is probably the broadest application of this principle—everyone knows that you don't need to wait for payment to arrive. However, it is unfortunate that the importance of determining the precise timing of an accounting event is sometimes ignored, resulting in misstated books and records. Understanding exactly when the title for goods passes between a buyer and a seller, or when a service is considered performed, is one of the most important accounting issues. The correct answers are tightly related to the nature of the business and the terms of each transaction; they need to be very well understood and interpreted in order to comply with established principles.
10. *Matching*: Directly related to the rules of recognition under the accrual basis, this principle also deals with timing of recording, and demands that corresponding revenues and expenses be recognized in the same period. This principle guides inventory capitalization rules and gives rise to prepaids and accruals. For example, even if a

company has paid for the freight of delivering a product from the supplier, this company cannot expense it until the product is sold. Likewise, even if sales commissions are not due to be paid until 90 days from the end of the sales period, a business must accrue them as expenses.

The last three principles, even though they are universally applicable just like the rest, may result in different interpretations, depending on the nature of a particular business. It is important to figure out how they affect the translation of your company's activities into accounting events to establish their proper reflection in the books, and ultimately in the financial statements.

Incoterms: The Recognition Tool

Assumed by many to be relevant exclusively to companies involved in international trade, the unfortunately named Incoterms (International Commercial Terms) actually regulate the split of responsibilities, risks, and ownership between a buyer and a seller for any entity engaged in procurement of physical products for further processing or any type of resale. It does not matter whether the goods cross any borders or the transaction takes place within the same country—the definitions and implications of these terms remain the same regardless of the circumstances. They even pertain to the relationships between individual consumers and retailers selling their product through catalogs or on the Internet: the reason your credit card charges coincide with the shipping records is because the terms of these transactions are FOB.

With the exception of the service industries, the accounting records of all businesses are affected by the correct understanding of what each of these purchase terms means, because *they determine the instant at which the product's title is transferred from the seller to the buyer, define the timing of the accounting event, and lock the proper date of revenue/purchase recognition*. They are so important and yet so overwhelmingly misunderstood that I feel it is necessary to provide the guidelines presented in Figure 26-1. The last four columns are particularly crucial, as they indicate when the ownership and the risk transfers occur, when the accounting events are recognized, and which supporting source documents are to be used for recording.

GROUP	TERMS	APPLICABLE MAIN CARRIER	DELIVERY TO MAIN CARRIER AND RELATED COSTS ARE PAID BY	MAIN CARRIER'S FREIGHT IS PAID BY	INSURANCE DURING MAIN CARRIER'S PASSAGE PAID BY	COSTS PAST THE MAIN CARRIER'S DISPATCH ARE PAID BY	OWNERSHIP TRANSFERS TO THE BUYER	RISK OF LOSS OR DAMAGE TRANSFERS TO THE BUYER	REVENUE/ PURCHASE RECOGNITION DATE	RECORDING SOURCE DOCUMENT
GROUP E	EX WORKS (I.E. PICK UP FROM MANUFACTURER) EX WAREHOUSE	ANY MODE OF TRANSPORT, INCLUDING MULTIMODAL	THE BUYER				AT THE SELLER'S OWN PREMISES	AT THE PICKUP	PICKUP AT SELLER'S	PICKUP RECEIPT
GROUP F	FCA (FREE CARRIER)	--	THE SELLER	THE BUYER			WHEN GOODS DELIVERED TO A CARRIER APPOINTED BY THE BUYER	AT THE MOMENT OF TRANSFER TO THE CARRIER	TRANSFER TO CARRIER	BILL OF LADING OR CARRIER'S RECEIPT
	FAS (FREE ALONGSIDE SHIP)	SEA AND INLAND WATERWAY						ON DELIVERY AT THE AGREED LOADING PLACE	DELIVERY FOR LOADING	PROOF OF DELIVERY (CARRIER'S RECEIPT)
	FOB (FREE ON BOARD)	ANY MODE OF TRANSPORT, INCLUDING MULTIMODAL						AT THE MOMENT OF LOADING ON BOARD	BOARDING	BILL OF LADING
GROUP C	CFR (COST AND FREIGHT)	ANY MODE OF TRANSPORT, INCLUDING MULTIMODAL	THE SELLER	BY THE SELLER TO A DESTINATION SPECIFICALLY INDICATED FOLLOWING THE TERM	THE BUYER	THE BUYER	AT THE MOMENT OF LOADING ONTO THE CARRIER (PASSING THE BOARD)	ON THE CARRIER'S DISPATCH	CARRIER'S DISPATCH (SHIPPING)	BILL OF LADING
	CIF (COST, INSURANCE AND FREIGHT)				THE SELLER					
	CPT (CARRIAGE PAID TO)				THE BUYER					
	CIP (CARRIAGE AND INSURANCE PAID TO)				THE SELLER					
GROUP D	DAF (DELIVERED AT FRONTIER)	ANY	THE SELLER			THE SELLER, EXCEPT DUTIES	ON DELIVERY TO A SPECIFIC DESTINATION	ON DELIVERY	DELIVERY	PROOF OF DELIVERY
	DES (DELIVERED EX SHIP)	WATER								
	DDU (DELIVERED DUTY UNPAID)	ANY								
	DEQ (DELIVERED EX QUAY)	WATER								
	DDP (DELIVERED DUTY PAID)	ANY								CUSTOM CLEARANCE DOCS

Figure 26-1. Commercial terms and ownership transfer (courtesy of E&D CC)

I must mention that group C usually represents the biggest source of confusion. Because the cost of transportation to the agreed destination is paid by the seller, many buyers assume that the risk and ownership are transferred on delivery, which is wrong. As you can see in the figure, the sale/purchase takes place as soon as the product passes to the carrier. Some companies discover their misunderstanding of the matter the hard way. For example, I've heard stories from insurance brokers dealing with cargos lost during Hurricane Katrina in 2005. It came as a shock to many business owners that they were responsible for paying their suppliers for product bought on cost and freight (CFR) and cost, insurance, and freight (CIF) terms—they had no clue that it belonged to them while it was on the water. Listening to these stories, I kept thinking about all those misstated financial statements with years of purchases recorded on the wrong date.

Ever-Evolving Body of Regulations

Business environments constantly change, new industries emerge, products of a previously unknown nature come to the market, innovative ways of earning revenues become everyday reality, and all of it still needs to be interpreted from an accounting point of view, set into procedures, recorded, and translated into financial statements. Moreover, everyone exposed to the changes must use standardized rules, so there can be no misunderstandings.

In step with these changes, accounting theory and its practical applications constantly evolve, addressing individual issues with new pronouncements and positions.

For many years, the American Institute of Certified Public Accountants (AICPA) took charge of the process of developing standards, rules, and regulations, first through its Committee on Accounting Procedures (1936–1959) and later through the Accounting Principles Board (1959–1973). Since 1973, the duty of developing new statements of financial accounting standards (SFAS,) for nongovernmental entities rests in the hands of FASB, established as an independent not-for-profit organization. AICPA still plays a significant role by issuing statements of positions (SOPs) on various specific matters, which, after being cleared by FASB, become accepted practices in the related industries.

The globalization of business, including the new ability of delivering soft products and services that cross all borders via the Internet, exposed many companies to the variations of foreign accounting. This led to the formation of the International Accounting Standards Board and the development of International Financial Reporting Standards (IFRS), which have the main goal of making the international comparisons as easy as possible.

Each of these organizations has its own online research portal. All CFOs and controllers should be aware of those standards that specifically pertain to their financial statements. If you have foreign currency transactions, for example, you must take a look at FAS 52, on foreign currency translations; companies with investments in other entities should account for them in accordance with FAS 115; and those with investments in financial instruments (derivatives) should be guided by SFAS 133 and all the amendments that followed its issue.

It is not really necessary for a corporate accounting manager to study every single regulation, but it is important to know where to look for the relevant one in order to ensure your compliance. Most importantly, keep your eyes and ears open to hot topics in discussion. AICPA and FASB eventually react to new business developments. When in the early 2000s financial brokers started packaging delinquent debt into securities and the entire industry that trades them formed, AICPA responded in 2003 with SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, which affected every single asset management company. The latest hot topic has been the revenue recognition for providers of *software as a service*.

So, if you are in a new industry or deal with products that have not been on the market before—or if something does not quite fit your understanding of

accounting rules—don't ignore it. Do your research and be attuned to the possible changes in standards. Even if your financial statements are audited by one of the larger CPA firms, don't wait for them to alert you—they have a lot of clients. It is your job to know what makes your books correct and financial statements compliant.

Accounting Cycles and the Structure of Financial Statements

In Chapter 8, the concept of accounting (or transactional) cycles was used to separate quintessential tasks into functional groups with closely related procedures: financing/investing, expenditure, conversion, and revenue cycles. Generally speaking, this is the most sensible basis for building any type of accounting framework, from charts of accounts to budgets and analytical systems, because each cycle encompasses specific categories of transactions and account balances, reflecting a sector of related business events in a company's books.

Understanding the relationship between transactional cycles and financial statements as it applies to your business guarantees higher-quality financial reporting. Moreover, auditors use a transactional cycle approach in their examination of books and records, evaluation of internal control, and assessment of risks. Having well-constructed statements accommodates a better understanding of the company's activities and their translation into accounting events by

Chapter 27 | Accounting Cycles and the Structure of Financial Statements

anyone who needs to analyze them; not just auditors and tax preparers, but also lenders, investors, and anyone conducting a due diligence exercise.

It starts with building the chart of accounts within your software. You usually have the option of giving each account two designations. The first indicates whether it belongs to the balance sheet or the income statement. The other corresponds to the transactional cycles (revenue, expenses, COGS, cash, receivables, payables, etc.). With a few variations, virtually all programs nowadays have a very similar setup interface. Some programs go even further, offering a user to pick a type of business and respond with an equivalent pre-built chart of accounts that accommodates the correlation between accounting cycles and the structure of financial statements. You can take this route if it fits your needs perfectly (or requires only minor adjustments). Otherwise, custom tailoring is always recommended.

The treatment of COGS in income statements requires a special note here. Conventionally, only manufacturing companies are considered to have a true conversion cycle with materials going through production processes. However, the act of creating services or adding value to products, as it is done by entities in the service and trading industries, is in essence an operational transformation. It involves allocation of special labor and other expenses, which are very different from those usually included in overhead. In a call center, for example, employees fulfilling customer service functions on behalf of clients represent operational labor, and it would not be correct to record their wages in the same account as that of the receptionist's in the front office. It is sort of a quasi-conversion cycle that gives rise to cost of goods/services sold in any type of business.

The diagram in Figure 27-1 represents a generalized arrangement of transactional cycles fitting to most companies' activities.

Keep in mind that changes in equity and cash flow are not primary statements—they are derivatives of the main ones: two consecutive balance sheets and the current income statement. It is the makeup of these core statements that is directly impacted by the transactional cycles. Regardless of the company's specifics, all balance sheets and income statements are organized in the same standard manner, which is very helpful as a constructional guideline.

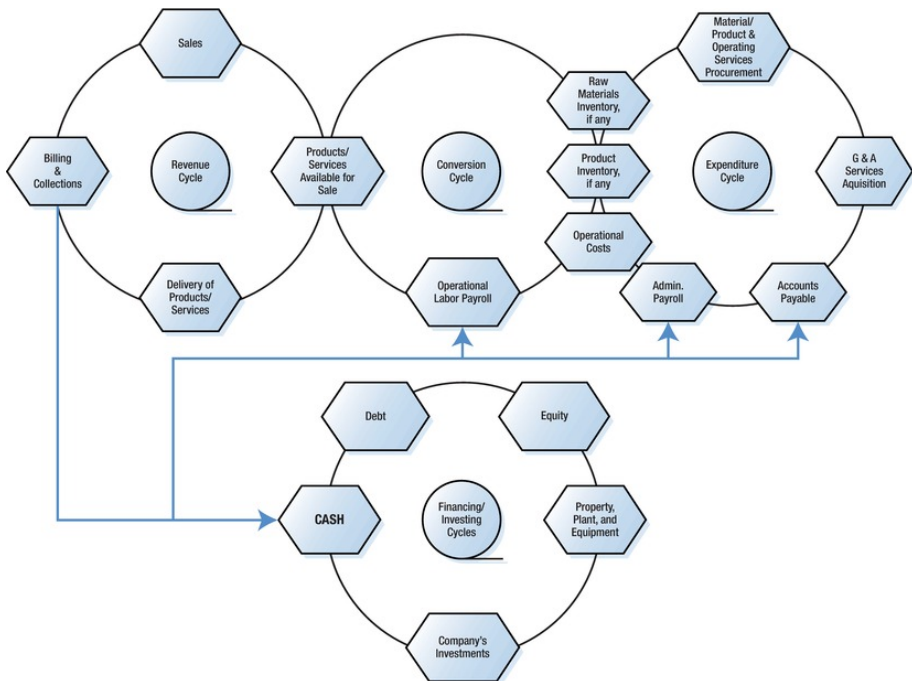


Figure 27-1. Typical transactional cycles

Balance Sheets

Standard components of balance sheets include the following aggregate accounting categories:

- **Assets:**
 - *Current assets (those with turnover under 12 months), listed in the order of their liquidity:* Cash, inventories, receivables (less allowance for bad debt), and so on.
 - *Fixed assets:* Property, plant, equipment, furniture, fixtures (all reduced by accumulated depreciation), investment property, intangible assets (less accumulated amortization), financial assets (non-equity investments), and equity investments.
- **Liabilities:**
 - *Current liabilities (those maturing in less than 12 months):* Payables, short-term financial liabilities, tax liabilities, contingent liabilities, deferred income, and so on.

- *Long-term liabilities*: Obligations with a maturity date over one year.
- Equity:
 - Issued capital
 - Non-controlling capital
 - Retained earnings
 - Capital reserves

Income Statements

All income statements adhere to the following basic structure:

Revenue

Less: Cost of goods sold

Resulting gross profit

Less: General and administrative expenses

Other income

Less: Other expenses

Resulting income before taxes

Income taxes

Net income

■ **Caution** In accordance with the previously discussed matching principle, only the revenue cycle can establish how material purchases and operational expenses will be reflected in the financial statements: expensed as COGS in an income statement, or capitalized in the balance sheet's current assets section.

Besides separating accounts among the primary statements, there are several other important things to remember when building a chart of accounts that will help adequately translate the nature of your business into the financial reports. First of all, most systems follow numerical order logic. Therefore, items that you want to be listed first in your statements must have

smaller account numbers. For example, all of your current liabilities should be numbered with combinations that start with smaller digits than the long-term liabilities. Otherwise, they may show up in the wrong part of your balance sheet.

Also, by its nature, the income statement, driven by expenditure, conversion, and revenue cycles, has a 12-month life span—at the end of a fiscal year we close the net result (income summary) into the retained-earnings account. This is why all corresponding balance sheet accounts are situated in the current section: AR, AP, inventories, and so on.

The financing/investing cycle is confined to the balance sheet realm. The rest of the cycles are largely responsible for the interaction of income statement and balance sheet general ledger accounts. And this responsibility of establishing the clear correspondence between the accounts becomes a key task in constructing sensible financial statements.

For example, if you buy four types of material (or goods for resale) and set up four purchase general ledger accounts, it is highly advisable to set up four corresponding inventory accounts. Moreover, make sure that the account number structures are aligned to reflect the relationship within each purchase/inventory pair. This will make the ledger more comprehensible and list corresponding accounts on the balance sheet and income statement in the same order. Furthermore, if you have an inventory module, it will ease the setup of automatic recording of purchased materials as inventory items and their subsequent transfers into COGS.

By the same token, if you provide services to starkly different groups of customers and would like to separate them into specific receivable accounts, it would be a good idea to set up matching revenues as well. For some companies, the correlation of accounts through the entire chain of cycles may be appropriate: from purchases and payables through inventories and COGS to sales and receivables. You must evaluate the transactions within each of the accounting cycles and define for them the best path into the company's financial results.

The table in Figure 27-2 provides the basic correlation between transactions that typically occur within each accounting cycle and the way they are reflected in financial statements. Knowing the transactional associations between income statement and balance sheet accounts can serve as an aid for charting them in a way that clearly reveals the nature of the company's activities.

Chapter 27 | Accounting Cycles and the Structure of Financial Statements

Cycle	Transaction Type	Accounts	Financial Statement/Section
Financing/Investing Cycle	Capital is received from investors	Cash (receipts)	B/S Balance Sheet - Current Assets
		Equity	B/S Balance Sheet - Equity
		Cash (receipts)	B/S Balance Sheet - Current Assets
	Capital is borrowed from lenders	Loans/Notes Payable	B/S Balance Sheet - Short/Long Term-Liabilities, depending on the repayment conditions
		Income Summary Account	I/S Net of Income Statement
	Operating income is earned/losses are incurred	Retained Earnings	B/S Balance Sheet - Equity
		Fixed Assets	B/S Balance Sheet - Non-current Assets
	Property, plant, equipment, furniture, fixtures, etc. acquisitions	Cash (disbursements)	B/S Balance Sheet - Current Assets
		Intellectual property is created internally	<i>Not recorded, even if revenue is generated through licensing</i>
	Funds are invested	Investments	B/S Balance Sheet - Current/Non-Current Assets, depending on holding period
Cash (disbursements)		B/S Balance Sheet - Current Assets	
Expenditure Cycle	Materials/Product are purchased on credit terms	Purchases	<i>Determined by revenue cycle</i>
		Accounts Payable	B/S Balance Sheet - Current Liabilities
	Materials/Product are purchased with cash	Purchases	<i>Determined by revenue cycle</i>
		Cash (disbursements)	B/S Balance Sheet - Current Assets
	Operational services are acquired	Purchases	<i>Determined by revenue cycle</i>
		Accounts Payable (if not billed - accrued expenses)	B/S Balance Sheet - Current Liabilities
	Administrative labor is engaged	Payroll Expenses	I/S Income Statements - G & A
		Payroll Liabilities	B/S Balance Sheet - Current Liabilities
	General and administrative (G & A) services are acquired	Expenses	I/S Income Statements - G & A
		Accounts Payable	B/S Balance Sheet - Current Liabilities
	Credit bills are paid	Accounts Payable	B/S Balance Sheet - Current Liabilities
		Cash (disbursements)	B/S Balance Sheet - Current Assets
	Payroll liabilities (both operational and G & A) are paid	Payroll Liabilities	B/S Balance Sheet - Current Liabilities
		Cash (disbursements)	B/S Balance Sheet - Current Assets
G & A accrued expenses are determined	Expenses	I/S Income Statements - G & A	
	Accrued Expenses	B/S Balance Sheet - Current Liabilities	
Prepaid expenses are determined	Prepaid Expenses	B/S Balance Sheet - Current Assets	
	Expenses	I/S Income Statements - G & A	
Conversion Cycle	Materials are held for production	Material Inventories	B/S Balance Sheet - Current Assets
		Purchases	<i>Determined by revenue cycle</i>
		Payroll Expenses	<i>Determined by revenue cycle</i>
	Operational labor is engaged	Payroll Liabilities	B/S Balance Sheet - Current Liabilities
		Product Inventories	B/S Balance Sheet - Current Assets
	Materials are converted into products	Material Inventories	B/S Balance Sheet - Current Assets
		Product Inventories	B/S Balance Sheet - Current Assets
	Operational costs are transferred to product (capitalized)	Purchases	<i>Determined by revenue cycle</i>
Product Inventories		B/S Balance Sheet - Current Assets	
Operational labor is transferred to product (capitalized)	Product Inventories	B/S Balance Sheet - Current Assets	
	Payroll Expenses	<i>Determined by revenue cycle</i>	
Revenue Cycle	Products/Services are sold	Accounts Receivable	B/S Balance Sheet - Current Assets
		Sales	I/S Income Statement - Revenue
	Cost of Goods Sold (COGS) is determined	<i>COGS (Purchases, Payroll, Operating Expenses)</i>	I/S Income Statement - COGS
		Product Inventories	B/S Balance Sheet - Current Assets
	Customers/clients' payments are collected	Cash (receipts)	B/S Balance Sheet - Current Assets
Accounts Receivable		B/S Balance Sheet - Current Assets	

Figure 27-2. Correlation between transactional cycles and the structure of financial statements

The Most Important Statement: Cash Flow

Anyone who is required by their professional duties to review financial statements of different companies in order to evaluate their performance—investment analysts, lenders, D&B rating experts and other credit specialists, and all accounting professors and members of various standards boards—will tell you that you can gather more valuable information about a company's health from its cash flow statements than from any other part of the standard financial reporting package. This recognition of the report's importance is grounded in the same reasoning that places treasury management (discussed in Part 4 of this book) higher on my priority list than conventional accounting issues: having grand revenue volumes and booking impressive net incomes does not guarantee that a company will have sufficient funds tomorrow to pay its payroll tax obligations or rent.

Even though common sense makes the value of the cash flow statement obvious, it took a while for it to make its way into formal financial disclosure requirements. Since the early 1970s, FASB has been trying to work out the reporting provisions and definitions for cash flow statements. Only in 1987 did FAS 95 make the cash flow statement a mandatory part of a company's

financial statements. Thus, the fact that revenues and expenses recorded on accrual basis produce paper profits and cannot be used to assess a company's viability in the way that positive cash flow allows us to do was officially recognized.

The purpose of a cash flow statement is to provide insight into the following crucial indicators:

- The company's liquidity and solvency
- The nature of the dynamics affecting the company's assets, liabilities, and equities
- The company's ability to improve its future cash flows
- Estimates of volume, timing, and probability of future cash flows

In order to fulfill these functions, the statement examines the changes in cash flows generated by the company's activities, which are separated by their nature into three categories:

- *Operating activities*, including all revenue-generating activities of producing and selling goods and/or services (sales receipts, payments related to procurement of materials, supplies, services, and labor), short-term borrowing activities (operating and trading loan receipts and repayments, and related interest payments), and short-term investing activities (interest and dividends receipts, proceeds from equity-trading activities, etc.)
- *Investing activities* (i.e., the company's investments), including purchase and disposition of assets (plants, equipment, marketable securities, etc.), loans made to suppliers or received from customers, and mergers and acquisitions
- *Financing activities* (i.e., investments into the company), including issue of debt instruments and long-term borrowing (proceeds, principal, and interest payments), capital leases (repayments only, since the obtaining of the related assets does not involve cash and is disclosed separately), repurchase of the company's stock, and payments of dividends and distributions

Because the statement is concerned with *the changes* these activities create in the cash balance, three basic financial statements are utilized in its preparation:

- The income statement, covering the same fiscal period, to obtain the net income figure as a starting point of the cash flow calculation

- Two consecutive balance sheets (previous and current year), flanking the beginning and the end of the period, for calculation of incremental changes (inflows and outflows) in each cash-related item

After adding all inflows and subtracting all outflows generated by the company's activities, we arrive at the number that represents *the change in the cash balance itself*. It is customarily used to reconcile the company's cash balances at the beginning and the end of the period.

Note that this is the only analytical report included in a formal set of financial statements. Its diagnostic quality separates it from the passive nature of the balance sheet's momentary snapshot and the income statement's summary of the period's events. Of course, there is a slew of ratio-based calculations one can perform with the numbers provided by those other two documents in order to assess such parameters as turnover, leverage, and profitability. Yet it is up to the users of the reports to conduct such manipulations. But the cash flow statement does not require any additional calculations. It's *an analytical instrument that gives you an instant understanding of a company's ability to meet its immediate payment obligations and a pretty good idea about the quality of the treasury function*.

So, it is unfortunate that the majority of smaller companies' owners, who theoretically constitute the core audience of this particular report, don't really know how to read it. So many executives have admitted to me that they don't understand the cash flow statement that I have come to the conclusion that it must be a dominant trend. Moreover, many less-proficient financial professionals seem to be uncomfortable with this great tool. But cash flow is not Fermat's Last Theorem, and if you know its purpose and understand its logic, it becomes clear enough to explain to anyone.

For educational purposes, I must mention the *direct method* of generating a cash flow statement, which is a cash-basis approach that uses actual cash receipts and cash payments during the period, extracted from the accounting records. Even though the resulting report appears to be easier to read, it is essentially disconnected from the balance sheet and income statement reports and relies on a separate calculation of cash inflow and outflow. The *indirect method*, on the other hand, essentially converts the accrual net income from the profit-and-loss statement for the period into cash flow, utilizing changes in the balance sheet items over the same period. It is a prevailing method prescribed by GAAP.

Learning how to correctly interpret these changes in the balances of assets, liabilities, and equity items ensures a firm grasp on the essence of this most valuable of financial statements. I will use the cash flow statement presented

in Figure 28-1 as a case study to provide explanations for the treatment of some of the most notable items. Since the reporting of small and midsize private businesses is somewhat informal, you may have seen and used various formats with different names for individual items. In some reports, you might see “Change in accounts receivable,” while in others you might see “Accounts receivable activity.” I have deliberately used a descriptive approach, identifying the effect that a particular item’s change between the beginning and the end of the period will have on the cash position. This should provide you with a guideline to proper treatment of each cash-related activity.

XYZ Company, Inc.
Cash Flow Statement
For the Periods Ended December 31, 2010 and December 31, 2009

	YTD Changes	Last YTD Change
Net Income	\$1,081,077	\$681,851
Adjustments to Reconcile Net Income to Cash Flows:		
Cash Flows from Operating Activities		
Decrease (increase) in accounts receivable	(7,875,866)	(695,174)
Decrease (increase) in inventory	247,385	2,076,661
Decrease (increase) in prepaid expenses & advances	418,952	(2,805,232)
Increase (decrease) in accounts payable	(679,639)	2,562,713
Increase (decrease) in short-term loans payable	7,905,305	179,321
Increase (decrease) in other payables	971	34,164
Increase (decrease) in unearned Income	-	-
Increase (decrease) in accrued expenses & other current liabilities	399,747	(317,989)
Depreciation and amortization	1,137	1,818
Total Cash Flows from Operating Activities	1,499,069	1,718,133
Cash Flows from Investing Activities		
Purchases of Assets	(12,650)	(765)
Disposition of Assets	-	-
Investments	(158,000)	-
Total Cash Flows from Investing Activities	(170,650)	(765)
Cash Flows from Financing Activities		
Issue of Common Stock	-	-
Purchases of Treasury Stock	-	-
Dividends Paid	(400,000)	(460,000)
Total Cash Flows from Financing Activities	(400,000)	(460,000)
Increase (Decrease) in Cash	928,419	1,257,368
Cash at the beginning of period	1,495,466	238,098
Cash at the end of period	<u>2,423,885</u>	<u>1,495,466</u>

Figure 28-1. Cash flow statement (courtesy of E&D CC)

Since the cash flow statement's calculation goal is to determine change in cash, each activity item is examined from the vantage point of whether its change gives rise to or reduces cash (these definitions of positive and negative effects on the cash flow are sometimes referred to as *adjustment rules*):

- The faster you collect your receivables, the better the cash flow. An increase in AR balance between the beginning and the end of the year signifies slower collections and has a negative effect on cash. Hence, it is treated as a deduction. A decrease in AR balance would be indicative of an additional cash inflow, and the increment's sign would be turned to positive.
- Holding inventories slows the revenue generation down and reduces the potential for cash inflows. A buildup of inventory by the end of the period shows that resources were used without a matching incoming cash flow—a deduction. As shown in Figure 28-1, XYZ Company apparently experienced high rates of inventory liquidation, which decreased its balance by about \$250,000. This is added to the cash flow calculation.
- When you pay for goods and services in advance, it means that the outflow of cash takes place before the benefits can be used in your operating activities to generate revenue. Therefore, if the balance is higher at the end of the period, then there has been an outflow. A reduction in advances and prepaids shows an improvement in the treasury management, either through elimination of such terms of payment altogether or shortening of the time that these items remain outstanding—an addition to the cash inflow.
- Increases in any types of current liabilities, including all payables and accruals, signify either receipts of more payments (operating loans, unearned income, etc.) or receipts of goods/services that can be used in revenue-generating activities before the company pays for them (AP, accruals, etc.)—all of which are positive. On the other hand, reductions of liabilities would mean more repayments than receipts and result in a net outflow.
- The determination of cash flow effects for investing and financing activities is more straightforward. There are no hidden implications—it's all about actual payments and receipts. Every time assets or investment instruments are obtained, an outflow of cash takes place—a reduction. Divesting of such items brings cash in—an addition. Raising capital through issue of debt or equity instruments by

definition brings money in. On the other hand, if a company buys stock back or pays dividends, cash goes out.

That's all there is to it. If you ever encounter an item that is not explicitly mentioned here, just apply the same logical principles to classify it.

All operating activities are featured in cash flow statements, including non-cash items such as depreciation, amortization, and deferred tax, which are added back to the net income when it's converted into the cash flow. However, investing and financing activities that don't involve cash and don't have an impact on net income are not included here. Some examples of such transactions are leasing of assets, debt-to-equity conversions, non-cash exchanges of assets and liabilities, and stock issues in exchange for assets. These events are usually disclosed in the financial statement's footnotes.

Besides concluding that XYZ Company is solvent and has sufficient liquidity, we can also note that the increase in AR is most likely a result of sales volume growth fueled by an increase in borrowing (both are nearly identical). We can gather that the company's products are selling well and the inventory's turnover is satisfactory, since the inventory balance has decreased (even though not as much as in the previous year). And while the CFO or controller needs to work on getting better terms with the vendors to slow down the payables' outflow, she obviously did a great job with the significant reduction of prepaids and advances.

A cash flow statement is a great source of invaluable information that can be put to good use by a company's financial and executive top management, as long as it is fully understood and correctly interpreted.

Choose Your Auditors Wisely

This personal aphorism of mine actually goes, “Choose your auditors wisely and teach them everything you know,” but that would make for too long of a chapter title. I will address the teaching part at the end of this chapter.

And I say “auditors” in a very broad sense. Millions of small and midsize companies never get their books formally audited, because they have no use for an *unqualified opinion*.¹ Yet practically all corporations engage some sort of public accounting and/or taxation service—for compilations of financial statements from the company’s records, reviews, state of business evaluations, preparation of tax returns, and so on. I could collectively call them Certified Public Accountants (CPAs), but that would be confusing. Many CPAs work in corporate finance and accounting, quite few of them as CFOs and controllers. So, the few important principles highlighted in this chapter pertain to firms providing any type of independent accounting work, not just audits.

Accounting Firm Selection Criteria

The only time a company’s management does not have a say in which accounting firm to hire is when an entity is backed by venture, hedge fund, or

¹ An auditor’s formal report concluding that a company’s financial statements present a true and fair view, in all material respect, of its financial position in accordance with the financial reporting framework applicable to the entity (GAAP, IFRS, etc.).

private equity capital. The investors are likely to impose on their portfolio companies the auditors that satisfy their exit strategy—most likely one of the Big Four (Deloitte, Ernst & Young, PricewaterhouseCoopers, and KPMG). In the majority of other cases, the decision is unrestrained.

The truth is that, at the beginning of their entrepreneurial journeys, many private companies' owners go to someone they know or to someone who was recommended by someone they know; frequently, it is a one-person practitioner or a very small firm. If the business is successful, its needs eventually outgrow the service provider's capacities. In another scenario, you may have a long-term relationship with a firm, but it merges with another one and stops being a good fit. Sometimes these mergers result in huge fee hikes and the cost becomes unaffordable. Or, you get new financing and need to upgrade your auditors to satisfy lenders' and investors' requirements. Whatever the reason for your being faced with the necessity of selecting new independent accountants, the choice should be founded on a logical set of criteria that will yield a satisfactory match. The following guidelines are intended to help narrow down the selection.

Purpose

At least at the beginning, looking for an auditor isn't really much different than looking for any other professional service (e.g., a doctor or an attorney). You don't go to an injury lawyer if you are seeking a divorce (even though it may sound appropriate). So, there is no reason to hire Deloitte if all you need is a straightforward, single-company corporate tax return based on the trial balance you prepared. You can use H&R Block Small Business Services for that. I also happen to think that, with some exceptions, the Big Four are culturally not the best options for small and midsize companies.

However, if the company's strategic plans involve going public or being acquired by a big industry player, your choice should have a nationally recognizable name and an impressive track record of similar deals. On the other hand, if you seek assistance with multistate taxes or transfer price issues, look for firms with strong taxation departments. If it's not just accounting but consulting support that you require, look specifically for the companies that cover the precise areas where you need help, whether that is policies and internal control revisions, or performance analytics, budgeting, and other instrument development.

CFOs and controllers of privately held small and midsize companies with standard audit-plus-taxes needs have to do a lot of legwork in the selection process, because the number of firms providing such services is huge. Of

course, Google makes all types of research easier nowadays. You can type “top 100 accounting firms” in the search box and get an interactive list that lets you quickly explore the companies’ sites one by one. Or, you can type “state payroll tax services Harrison, PA,” and relevant results will come back to you within seconds. Another possible starting point for the first stages in the selection process is GoodAccountants.com. It is a free service that lets you select from over 25 primary accounting areas of interest. With minimal information about your business, it finds possible candidates from its national registry of thousands of small CPA firms and individual professionals. (They are the ones who pay for this brokerage—the entry fee is \$5,000.) You can get from this site an initial list of providers of the particular services you need, and then narrow it down based on other criteria.

Business Sector Specialization

Most large and very large firms (let’s say the top 20) cover all possible services (accounting and auditing, taxation, forensics, business consulting, risk, compliance, etc.), and also have specialists on staff for practically all industries, especially the ones that bring in big bucks through equity financing and IPOs. At the onset of the Internet bubble, around 1995, all the top-tier firms (at the time it was Big 5 with Arthur Andersen still in the game before it got Enroned) formed technology divisions; they learned how to trace every online customer’s mouse clicks to the revenue records.

Middle-market and smaller firms, however, tend to specialize in certain business sectors, so the hire-who-you-know tradition can lead to some unfortunate outcomes. For example, I have known of international commodity-trading companies that used accounting firms with 99% of their clients in apparel and footwear. As a result, these companies’ tax returns lacked mandatory forms disclosing foreign bank and financial accounts. An even a worse example would be a structurally complex financial service using a personal taxation practitioner for its independent accounting needs and having the books of all its subsidiaries commingled.

Whatever you use it for, you are much better off with a firm that either has broad expertise or, through its clientele, has gained sufficient understanding of your industry’s specifics and the applicable reporting requirements. Again, you can search online, but there are other ways of locating specialists as well. In most industries, competitors know each other well. They meet at conventions and trade shows, they steal each other’s key salespeople, and so on; in other words, you or your CEO most likely knows someone to ask about independent accountants. Your bank officers, who frequently have clients in

similar businesses, represent another good source for this information. The same goes for factoring services. Just ask around—it's worth the effort.

Geographical Exposure

A frequent argument for going with one of the Big Four companies is their international presence. They are in all commercial and financial centers around the world, and if you work for a company with foreign subsidiaries, currency translations, and financial statements' consolidation, it actually makes sense to deal with a firm that can dispatch its local staff to your overseas offices if needed. Most second-tier companies are multistate. They are usually also members of Nexia International, a worldwide network of independent firms, which helps them to refer you to a local firm in another country. However, be wary of such referrals, because it is very possible that a firm has never worked with its foreign connection before and cannot guarantee its proficiency.

Even without such complications, geographical spread is an important factor. It is much less relevant for consulting and analytical services, which with current technology can be conducted remotely. However, when it comes to auditing and accounting help, you definitely want somebody with an office in your vicinity. Depending on your remoteness from major business hubs, this criterion may be the first one to consider before weighing anything else.

Reputation

If a service provider is not referred to you by someone who can attest to the quality, reliability, and integrity of his work, you will have to rely on whatever other sources of information are available. Smaller firms with lesser-known names frequently post their clients' testimonials online. Do not hesitate to ask for references and speak to other CFOs and controllers who use this firm. Finally, you can ask for a *peer review* report, which contains conclusions on the quality of accounting, auditing, and taxation services compiled by an AICPA authorized reviewer.

Acceptability to the Financial Statements' Users

Some people say that the only time you need audited financial statements is when you are looking for financing. This is mostly true, and many companies do fine with a compilation or a review, or even an internal financial statement. Yet there are some other entities, besides lenders and investors, that

require a CPA's signature on annual reports. State licensing agencies responsible for regulated industries and assurance bond underwriters are just a couple of examples. Also, you may be able to get away with an independent accountant's opinion, if it's a matter of a small credit line or loan. But if there are millions of dollars at stake, bankers and capital holders can be picky about the particular auditing firm you use. At the very least, they want someone reputable and prefer a familiar name. If you know that obtaining a credit line or searching for investors is a future possibility, you should take that into consideration when selecting a new company. The peer review may come in handy here as well—if you like your present auditors and they do a good job, ask them to make a presentation to the bankers, thus turning them from questionable to acceptable.

Price

This is where the Big Four eliminate themselves from the picture for most privately held companies with no going-public dreams—their fees do not fit into your budgets. Cost/benefit concerns are very important in these decisions. It's OK to spend \$40,000 a year for audited financial statements and corporate tax returns if you need to renew \$75 million worth of operational credit lines. But it is not OK to pay 10% of your net income to auditors for the sake of a \$500,000 revolving credit line. Also, as with any professional services, keep in mind that you always need to fight for the flat rate. You cannot rely on how quickly different members of the independent team can work—they are not your employees, so you don't even have the option of adjusting their performance. So, figure out the appropriate annual fee, take off 15%, and then start negotiating.

Quality Control

Quality-control issues apply only to those companies that get their financial statements formally audited. And the reality is that there is not much you can do about accounting firms' need to protect themselves from regulatory censure—every more or less sizable accounting firm has a quality control department. They receive the auditors' working papers and review them for accuracy and compliance before an opinion can be released. It does not hurt to casually ask about the quality control department's severity when you interview prospective service providers. When you do so, pretend that you are Dr. Cal Lightman (Tim Roth) from *Lie to Me*: ignore the words and look for microexpressions. If you catch rolling eyes, that's a signal that the quality control is tough and the audit results may go back for more testing, disclosure, reinterpretation, and so on. Too-stringent quality procedures are not a

sufficient reason to dismiss a firm if it is a good match otherwise, but being aware of all possibilities is very helpful.

Teach Them Everything You Know

This point does not require a lengthy explanation, but its importance merits a separate header. You may succeed in finding the most suitable independent accounting firm, and its management may assign a team of sharp, informed, and likable people to your engagement. But every business is unique, and even though auditing methodologies are standard, the interpretation of information may be different depending on specifics. Expertise acquired dealing with one company can never be applied 100% to another. Just like we mold the fundamental knowledge base in our heads every time we take a position at a new company, auditors need to adapt their judgment to your business, financial, and accounting models.

At the same time, you cannot rely on auditors' own initiative—even the best of people have a tendency to take the path of least resistance. The problem is that if they don't ask questions, they will make assumptions. Then you run the danger of possibly wrong information distorting their work, and ultimately affecting the results you hired them to accomplish. This is not about personalities; it is about getting the job done properly. So you must take the matter into your own hands.

Whether it's you or your auditors who are new to your company, try to schedule a preliminary meeting dedicated to knowledge sharing with the auditors. Make sure that they understand the company's commercial mission, the business and corporate structures, the composition of capital financing, the principles of revenue and cost recognition you use, and so on. Share with them your policies and internal control practices. If there are complicated accounting issues that pertain specifically to the company, you should mention these as well—if the auditors are aware of them, they will be impressed by your proficiency. If they are not, they will go back and study them, and then they will be prepared.

Of course, you have to be very gentle and make an effort not to act like you know more than the independent professionals do—place an emphasis on the company's specifics. As always, there will be those who don't want to learn anything, and if you run into them, it means you're working with the wrong people. Go back to square one (or the beginning of this chapter) and start looking again.

For those of us who actually must go through formal audits, the next chapter provides a few tips on alleviating the pains of this process.

What Guarantees Fast and Painless Audits

No matter how optimized your schedule is, audits are disruptive for you and your staff. While you are answering auditors' questions and fulfilling their requests, nobody attends to the tasks of your daily routine. Even with the calendar cleared in advance, things will get backed up. That is why you must do whatever it takes to minimize the pain. Of course, having your books in order is the prerequisite, but there are other helpful tactics you can employ.

The Audit's Timing

Many CFOs and controllers make the mistake of thinking that they have until September to get last year's books audited or reviewed. They file a six-month extension for the corporate tax return on March 15 and assume that they can delay the external disturbance for several months. Theoretically, if it is not a full-scope audit with mandatory tests and disclosures, but just a review, compilation, or tax return preparation, delay it all you want.

However, if the requirement is a proper audit resulting in an unqualified opinion, then that's a poor strategy. In this case, the earlier the audit takes place, the better it is for you. My personal preference is the last week of

February, assuming December 31 is the end of the fiscal year, or 45 to 50 days after any other fiscal year's end. *The closer you are to the end of the audited year, the narrower the extent of the examination.*

In accordance with auditing standards, auditors are obligated to uncover, isolate, and test *subsequent events*—events that occurred between the date of the financial statements (let's say December 31) and the date of the auditors' report. The subsequent events fall into two categories:

- Events that result in adjusting the financial statements
- Events that require disclosure in the footnotes

In order to detect such events, the auditors must probe the transactions that took place during the months after the closing of the fiscal year under examination. It goes without saying that those CFOs and controllers who see their accountants sometime in July undergo much lengthier audits than the ones who are ready to face the music at the end of February.

Less obvious, but nevertheless important, is the consideration of an accounting firm's calendar, especially if you use a smaller firm that provides services to individual taxpayers as well. January and February are relatively slow months, with the majority of corporate clients closing their previous year's books and individuals awaiting W-2s and 1099s. So, the accountants are very eager to put you on the calendar as a February engagement and give their billable hours a boost. But beginning with the second week of March, they start getting busier every day. This means that they will work at a faster pace trying to wrap up whatever audits they have started in February as quickly as possible.

■ **Tip** If you start your audit at the end of February, the financial statements will not likely be finalized by March 15, the standard due date for corporate tax returns. Therefore, you will need to file for an extension (with IRS Form 7004). If you need to do this, remember that the extension is provided for the tax *return*, not the tax *payment*. It is allowed so that the companies can file the most accurate returns possible. Yet companies are still expected to pay at least 95% of the federal and state taxes by March 15; otherwise, they can incur nonpayment penalties.

Preparation Is Key

There is definitely something scholastic about the auditing process. The books get examined, independent professionals conduct tests, and everyone in accounting and finance feels a little bit apprehensive, just like before finals

at college (you can think of quarterly reviews, if you have them, as mid-terms). So, what can ensure excellent performance during exams? We all know the answer: hard preparatory work. The more groundwork you do in advance, the faster and smoother your team and the auditors' experience will be.

Seasoned CFOs and controllers usually have a good understanding of auditing principles. More importantly, they gain hands-on knowledge while going through audits year after year. So, they know very well what exactly the auditors need. But even if you are preparing for your very first books-examination exercise, you can achieve a high level of readiness by following your own common sense.

Take your *trial balance*—this is the first document the auditors must get, and it also serves as your syllabus. First of all, look for anything that can be confirmed externally. All cash and financing (loans and investments) account balances are always confirmed with bankers and financial institutions. If you use third-party warehouses, for example, your inventory balances will need to be confirmed as well. If you have corporate attorneys, they are obligated to confirm the existence and status of all litigations. Get the *confirmation letters* from the auditors as early as possible, and then fill and send them out right away. Banks are usually very good at replying quickly, but you cannot be sure about your other business partners. Sometimes, it takes up to three contacts to get confirmations from certain parties.

For every line on the balance sheet, you need a supporting breakdown: bank reconciliations and account statements for every month; AR schedule; inventory details; short-term investments' composition; itemizations of prepaids, security deposits, and accruals; AP, notes, and loans schedules; and whatever else you have there. The auditors need to see all forms of contracts, including deeds, leases, mortgages, credit line agreements, sales and purchase commitments, and insurance policies. Of course, payroll records and tax returns are included in the auditing working papers too.

It is impossible to confirm every single vendor or customer balance, but you can estimate the scope of testing based on the *materiality level*. You can figure out which vendors and customers will fall into the range of auditors' interest, and not only request the confirmation of balances, but also prepare the transactional details with all supporting documents in advance. The same idea applies to individual expense categories: the larger they are, the more likely they will be tested. For instance, if your annual revenue is \$100 million, and the company spent \$1 million on advertising, you can be sure that the auditors will want to see every single bill in that category.

In addition to verification of accounting accuracy and completeness, the auditors are responsible for expressing their opinion on the company's fiscal policies, internal controls, software adequacy, and so on. They use specifically designed documents to assess the relevant information, which are more or less standard. Yet, regardless of whether it is your first time with a particular accounting firm or you have been dealing with this firm for years, it is recommended to ask for the list of deliverables in advance. Sometimes, there are internal or profession-wide changes that may alter the auditing requirements, and you don't want to be caught unaware.

■ **Tip** One of the best ways of speeding up the audit process is to have the copies of supporting documents made for the auditors in advance. Otherwise, they will have to waste their field time on it. Many accounting firms are now paperless, so scanned files can be easily transmitted to them.

I am sure that by analogy, with the items described here, you can come up with other elements of preparation specific to your business. Working with your team in advance of the audit also gives you the benefit of timing the tasks at your own convenience rather than trying to accomplish them when people are breathing down your neck. If you have the necessary documents ready and clearly labeled, with the auditors' copies already made, as long as you haven't violated some accounting standards, the audit will run with minimal difficulties.

Instructions for Your Staff

Even superb preliminary work cannot eliminate additional onsite inquiries entirely. And as much as we want to streamline and expedite the auditing process, one thing I always try to avoid is letting auditors roam around the offices asking for source documents, schedules, and other information directly from accounting, operational, IT, and other staff. It's not like you have anything to hide, but you cannot coach every single person on the appropriateness of this or that request, the relevance of information as it pertains to accounting audits, the theory of cutoff tests, and so on.

These random encounters, especially when they involve junior auditors used by managers as gofers and junior members of the company's staff, have a potential for disturbing the schedules of too many people. They also frequently end up causing blunders and miscommunications, which further result in

time-wasting discussions and corrective efforts. Most importantly, you cannot guarantee a proper handling of the proprietary and privileged information by the auditors, unless they receive it with suitable warnings. You may end up with payroll records lying on some desk during lunch hour.

The first thing I always recommend is appointing a liaison—a well-trained and prepared accounting manager, or somebody in an equivalent capacity. If you don't have anybody like that, then it will have to be you. This person should be introduced to the auditors as their go-to contact for any requests they may have. He can also report the ongoing status and consult with you on issues beyond his level of competency.

However, you cannot really manage the working habits of independent professionals, so there is still a possibility of them going directly to other employees. So, the second thing to do is to provide the rest of the staff with simple but strict instructions to either send the auditors to the appointed manager or politely accept their requests and pass them in the right direction.

Make Auditors Feel Welcome

Many times I have observed auditors being treated by a company's senior management with irritable hostility. It almost feels like they are perceived as antagonists on the other side of the barricades. And it's understandable. With them poking into this and that event, questioning numbers, and making requests to see more, you cannot help but feel judged and possibly resentful. Yet, that is not just wrong, it is counterproductive.

You need their cooperation. You and your auditors pursue the same purpose: proving that your books are in good condition, all accounting events are translated in accordance with applicable standards, and the statements fairly reflect the company's financial condition. But we are all human beings, and there is a basic law of physics that translates well to this scenario: for every action, there is an equal and opposite reaction. If the outsiders feel unwelcome, they will be more inclined to make your life difficult. They cannot violate their professional code of ethics, but they can channel their reactive animosity in other ways. That kind of atmosphere is not conducive to quick audits.

Remember that the main target of your efforts is to manage a successful audit while diminishing its disruptive impact. The only way you can achieve it is by eliminating the need for a long *field examination* (i.e., the time auditors spend on your premises). They only need to stay until they finish conducting tests, collecting source documents, filling out questionnaires, and compiling

data that they can obtain only while in your office. After that, they can continue working on your material at their own desks, and usually they prefer that. Of course, there are always follow-up questions and requests, but they can be answered remotely and don't need to interfere with your normal working process as much.

If you know your stuff, comply with all accounting principles, and prepare for the audit in advance, the onsite part will be over in a matter of a few days. Then you will be able to check off the completion of last year's cycle on your functional roster and attend to the pressing responsibilities of the present.

Risk Management

There was a time when the only risk-prevention policy employed by accounting and finance professionals was to try to veto any innovative or enterprising initiative. That time has long passed. As a member of a commercial strategic team and the CEO's partner, a contemporary CFO must support opportune plans of business development that don't guarantee absolute success. Still, the uniqueness of a CFO's position is in its duality. While participating in risk-taking decisions, we remain concerned with the assessment of possible outcomes and try to minimize the uncertainties. Thus, most CFOs' agendas contain a complex of responsibilities focused on managing various risks, preventing possible pitfalls, and ensuring that the company is impervious to any dangers. Only by being prepared for future possibilities in advance can we justify our approval of any degree of unpredictability. As Niccolò Machiavelli taught in his treatise on governing all forms of organization, *The Prince (The Prince and The Art of War, CRW Publishing, 2004)*, "For it is by foreseeing difficulties from afar that they are easily provided against; but awaiting their near approach, remedies are no longer in time, for the malady has become incurable."

Insurable Risks

The daily existence of a business entity, just like a person's life, is teeming with possibilities for small mishaps and real misfortunes. This is especially true for dynamic entrepreneurial companies on the path of diversifying their activities and expanding their commercial horizons. Small and midsize companies are far more vulnerable to the impact of unforeseeable events than large enterprises. The monetary consequences of a single accident have the potential to close a small business with slim cash reserves. Alleviating the financial burdens that may result from various contingencies with the help of insurance is the most obvious method of dealing with the unpredictable future. Conceptually, it constitutes a risk management strategy: transferring the risk to another party—in this case, insurance policy underwriters. With sufficient knowledge of the subject matter, you can find policies that will cover payments associated with most trials and tribulations.

Essentially all insurable risks can be divided into three categories:

- Risks of damage to your tangible or intangible assets
- Risks (liabilities) that arise from casualties suffered by your employees in the course of business
- Risks (liabilities) that arise from property damage or personal harm caused to third parties in the course of business

There is a wide spectrum of commonly used and specialized business insurance products available to secure a variety of risks. The majority of people are aware of protection provided by such basic policies as the following:

- *General liability insurance*, which covers injuries that may be caused to third parties or their properties under common situations (e.g., accidents on your premises).
- *Property insurance*, which covers loss of and damage to business property caused by broadly defined accidents and some natural disasters.
- *Commercial automobile insurance*, which covers vehicles used in business. This type of insurance is usually designed as a combination of liability (to cover injured third parties) and property (to cover damage to your automobiles, trucks, buses, etc.) policies.
- *Workers' compensation insurance*, which primarily covers employees' on-the-job injuries. The majority of states make it mandatory for any business with at least one employee to carry some sort of workers' compensation insurance. On the flip side, the same states usually have laws preventing employees from bringing negligence lawsuits against an employer for work-related injuries, unless gross negligence on the part of the employer can be established.

■ **Note** Technically speaking, the government-mandated *unemployment* and *disability* contributions made by employers can be viewed as premium payments. Hence, the programs are rightfully called *insurances*. Unlike other commercial insurances, they don't cover business risks, but rather they protect employees from the risks of losing wages. A private disability policy is often a part of an employee benefit package.

Some specialized types of coverage are also very well known. *Malpractice insurance*, sometimes called professional liabilities insurance, is a good example. It covers court and settlement costs of doctors, dentists, attorneys, accountants, architects, real estate agents, and so on, in case their substandard professional conduct causes an injury to a third party. Sometimes it is difficult to say whether it exists because we live in the most litigious country in the world, or it's the other way around—the public goes to court knowing that there is malpractice insurance backing the defendant.

Other lesser-known, niche policies may be applicable to a particular business, and some are compulsory, depending on its industry. The following are some of the most prominent types of insurance designed to cover specific hazards and liabilities:

- *Product liability insurance* is one of the most important (and expensive) policies for manufacturers and traders (not just retailers, but also wholesalers, jobbers, and resellers) who produce and sell goods that may cause injuries when used by the general public (food, medicine, automobiles, toys, etc.) or through accidental exposure (e.g., hazardous materials). By definition, such insurance covers claims filed by anybody who buys and/or uses the product, as well as bystanders. In addition to covering defects or malfunctions related to design flaws, these policies also address manufacturing process problems (such as contamination of production lines), in-transit accidents, and improper or inadequate warnings and instructions. Wholesalers frequently think that because they don't sell directly to consumers, product liability is not their concern. But that is not correct—they are just as exposed as manufacturers and retailers.
- *Errors and omissions (E&O) insurance* covers injury to a third party caused by inadvertent mistakes or failures. The errors must not be deliberate or result from poor judgment (malpractice insurance covers the latter); they must result from a truly accidental occurrence. For example, if a shipping agent forgets to include a certificate of origin with a set of required documents, causing a delay in customs clearance that results in a payment of demurrage¹ by the importer, the freight forwarder's restitution of this expense should be covered by its E&O insurance.
- *Marine insurance* covers commercial goods during sea voyages, while *inland marine insurance* picks up the protection in transit on dry land and in storage. It can be taken both by the primary owner of the product and the third party with the temporary custody of the product (e.g., a service for restoring antiques can cover clients' items on its premises).
- *Business interruption insurance* covers lost income resulting from an inability to conduct business due to damage or loss of property. It usually takes the form of reimbursements of actual expenses incurred during the idle time (salaries, payroll taxes, rents, leases, etc.), plus the estimated net profits.

¹ Demurrage is a charge payable to the owner of a chartered vessel in case of a failure to load or unload cargo within an agreed time.

- *Crime insurance* covers theft, burglary, and robbery of the company's property (including money, securities, inventory, supplies, office equipment, and fixtures), committed either by employees or outsiders.
- In the United States, *terrorism* was transformed in everyone's mind from a nearly impossible cataclysm into a very real possibility on September 11, 2001. Nowadays, you will not find it on a list of risks covered by a standard property and casualty policy; a separate endorsement with an additional premium needs to be obtained. Moreover, insurance companies have not figured out yet how to model the probabilities of these events and still price these products similarly to those for natural catastrophe risks. The US government stepped into the picture with a reinsurance law—the Terrorism Risk Insurance Act (TRIA)—in November 2002. It provides for the federal backing of the private underwriters in the case of an overflow of terrorism claims. It was supposed to be a temporary measure to give the insurance industry time to develop adequate products. It has been extended twice so far and currently has an expiration date of December 31, 2014.
- *Political risk insurance* has been gaining popularity as globalization has begun to impact more industries. Companies in search of new markets and cheaper resources take chances conducting their business in regions susceptible to sudden changes in political climate that may result in losses. Political risk coverage is not limited to such violent acts as revolution, insurrection, civil unrest, and war. Government decrees resulting in expropriation or confiscation of assets, repudiation of contracts, and willful business interruption are also covered. Among the fiscal events that underwriters include in this category of casualties are wrongful recalling of LCs and other bank guarantees, inconvertibility of foreign currencies, and inability to repatriate funds.

■ **Note** History provides many examples of economic devastation caused by the overthrow of governments. Castro's revolution, which caused an immediate expropriation of all American properties and investments in Cuba, comes first to mind. But there is a more recent case that didn't involve any violent international shake-ups, and therefore went largely unnoticed by the general public while affecting a score of companies and several US industries.

After the fall of the Soviet Union in 1991, Russia found itself with deficits in pretty much everything, including food—particularly affordable proteins. The US suppliers of frozen chicken parts quickly seized this opportunity. Increased demand raised prices in the commodity market and gave poultry production a significant boost. Dedicated value chains were developed: large and small US ports, fleets of refrigerated vessels, newly formed export-trading companies, and so on. The process turned into a nonstop conveyor of production and delivery. It grew to be a multi-billion-dollar business within a couple of years.

By the end of 1990s, though, the Russian government, strengthened by the privatization and commercialization of its economy, woke up to the fact that its own agricultural producers couldn't compete with the volumes and prices delivered from overseas. As an act of protectionism, it declared that US poultry did not meet Russian sanitary standards and vetoed its importation. Even then—Vice President Gore's emergency visit to Moscow did not change anything. Vessels were turned away and had to come back at a great expense. Only vertically integrated giants like Tyson and Hudson Foods could survive such a blow. The prices tanked and inventories became completely devalued. Producers, packers, ports, and shipping companies involved in this trade suffered a severe contraction. Some time later, the moratorium was lifted, but the damage was already done. Many midsize and small exporters, not covered by specific political risk insurance, went out of business.

There are still more narrowly targeted types of coverage that cater to protecting companies from losses caused by particular events or that affect a particular named property. These include earthquake, flood, tornado, ordinance and law, builder's risk, glass, boiler and machinery, computer, and debris removal insurance. Still other types of insurance cover liabilities incurred as a result of explicit actions—these include employment practices insurance and directors and officers insurance. They are frequently used as add-on clauses to general liability and property insurance.

In fact, *multiline insurance policies*, which cover an entire spectrum of business risks, have become a popular and cost-effective alternatives to assembling a portfolio of various policies from different resources. Of course, there may be a hazard or two that even a large insurance provider will not be able to cover, creating a need for obtaining separate contracts. Nevertheless, the more endorsements you can combine together, the smaller the sum of the premiums will be, which is an important factor, as they are not cheap.

Of course, I also must mention *umbrella policies*, which can be added to any main policy. The name reflects the nature of this instrument, which enfolds many different endorsements within the overall coverage and provides policyholders not only with protection above and beyond the standard limit of each clause, but also fills gaps by covering incidents excluded from the primary list (e.g., libel, slander, and invasion of privacy). Umbrella insurance is usually sold in increments of \$1,000,000. Thus, a million-dollar policy, for example, effectively raises a \$300,000 auto liability limit to \$1,300,000.

Even though all insurance companies provide extensive opportunities to research their offerings online, when it comes to piecing together a complex package addressing all risks applicable to your company, you are still better off working with an experienced broker. Their services are free, as they are compensated by the insurance providers. Plus, to keep their clientele happy, they always help with problems and claims. It is important to find someone with a record of diligence: when making a proposal for a particular policy, a good broker should present you with at least three or four options.

Even if you enlist the best assistance, however, an external person will not be able to assess all possible risks as well as someone who knows the business inside and out. Therefore, it is very important for a CFO or controller to be well versed in the different types of coverage available for protecting the company from all eventualities.

Commercial Risks

Commercial risks are associated with an entity's way of conducting its business and the nature of its daily activities. Companies that use and accept foreign currencies; produce, consume, and trade raw materials or primary agricultural products; utilize financial instruments with adjustable interests; or construct their operations in such a way that it results in a concentration of risks are all exposed to a variety of potentially problematic events that can result in negative business adjustments, financial losses, and failure. Depending on the nature of these risks, various management strategies can be applied to them, including the transferring of the burden to another party, reducing probability of the risk, and minimizing its possible negative effects.

Schematically, we can divide commercial uncertainties into two groups. Let's call the first group *external risks*. They are usually beyond the company's direct management power and arise from global financial and economic changes. On the surface, it seems like small and midsize companies are helpless in the face of giant market movements. Yet the methodology of protecting a business from the negative effects of these risks is pretty straightforward. Decades of global economic development has led to the creation of specific defense mechanisms, such as various hedging instruments, available to companies of all sizes.

On the other hand, prevention of *internal risks* related to a company's development strategy, operational structure, sourcing, selling, and other daily business practices largely depends on establishment of specific commercial safeguards and the quality of executive management. Volumetric risks related

to changes in demand and risks of concentration (the proverbial “putting all your eggs into one basket”) are the reality of commercial existence. Yet their negative effects can be minimized through *diversification* efforts.

Trading credit risk stands alone as a sort of a hybrid. It is definitely an internal commercial risk, related to a company’s growth strategy, credit policy, and even individual judgment calls. At the same time, changes in the economic environment can affect the ability of customers to pay. Bad-debt risks can be minimized by the company’s expansion of the customer base, stricter credit procedures, and close monitoring of AR. Still, the prevalent nature of open credit relationships has led to the development of instruments that treat them both as insurable (discussed in Chapter 19) and hedgeable.

Hedging

The word *insurance* is frequently used when *hedging* is defined—not in the sense of a policy purchased from MetLife that pays you in case of a loss, but rather in its purely semantic interpretation: as something that provides protection against a possible eventuality. Unlike an insurance policy, hedging doesn’t target the possibility of a bad outcome, but the very probability of change. Under the principle of conservatism, we must take into account only a negative contingency. Still, by entering into a hedging contract, a company insulates itself from any shifts of specific parameters, whether they would result in losses or gains. And it’s a good thing, because commercial enterprises are not in the business of speculating in expectations (there are various market players for that); their purpose is to make profits by creating products and services. To do so successfully, they must avoid or at least diminish the impact of external factors.

In a general sense, hedging can be described as an action taken in an opposite direction from the original transaction, with the purpose of offsetting and balancing the possible risk. By that definition, the forfeiting of a term LC (a trading credit risk), previously discussed in Chapter 12, is fundamentally a hedging instrument. First, you agree to exchange your product for an LC with a payment deferred by 180 days (the action: accepting to hold), taking a risk that the issuing bank’s situation may deteriorate and it will not be able to honor the document six months from now. To offset this risk, you enter into a forfeiting market and sell this term LC (the opposite action: forgoing the holding) at a discount (a premium paid for insuring yourself against the default while transferring the risk to the third party).

Natural economic selection has led to development of hedging tools in most volatile markets, especially equity (stocks). Of all the risks associated with

commercial activities, three have gained prominence as hedgeable: shifts in commodity prices, foreign currency exchange–rate movements, and cost of money (interest rate) adjustments.

Commodity Hedging

You may have seen the film *Trading Places*, with Eddie Murphy and Dan Akroyd. If you ask most people who have seen it what exactly the rich brothers, Randolph and Mortimer, did for a living, most will say, “Something on the stock market.” That would be incorrect—the brothers were active members of one of the oldest *commodity markets* in the world: the New York Mercantile Exchange (NYMEX), founded in 1882 (there are nearly 60 commodity exchanges worldwide). The entertaining commotion created at the end of the movie on the trading floor of frozen concentrated orange juice (FCOJ) was supposedly caused by the brothers’ attempt to corner the market by speculating on a major price shift; an attempt that failed because they found themselves on the wrong side of the shift.

In reality, it could never have happened, because the commodity players—both producers (the sellers) and manufacturing processors or distributors (the buyers)—habitually protect themselves from the demand and supply adjustments that affect market prices by using hedging mechanisms. There are not too many products characterized by sufficient global demand to qualify as commodities. But those few are so crucial to world’s economy that they affect manufacturers and traders of all sizes in many industries. They are usually divided into four groups: agricultural (corn, oats, soybeans, soybean oil, rice, wheat, milk, cocoa, coffee, sugar, FCOJ), lean hogs, frozen pork bellies, and live cattle); energy (crude oil, ethanol, natural gas, heating oil, gasoline, propane, and purified terephthalic acid); precious and industrial metals (gold, platinum, palladium, silver, copper, lead, zinc, tin, aluminum, nickel, cobalt, and molybdenum), and other (rubber, palm oil, wool, polypropylene, and linear long-density polyethylene).

The simplest way to prevent exposure to future price fluctuations is to enter into a *forward contract*, which fixes the delivered/accepted quantity, the delivery date, and the future price estimated based on today’s knowledge (*forward price*). This way, the producer evaluates the volume he will be able to yield in a certain period of time, and fixes the sales price that should cover all his expenses and produce a profit. The buyer agrees to take the delivery of the product at that time and at the fixed price, which he, in his turn, can use to calculate his own production costs and/or resale prices. Regardless of whether the market moves up or down by the forward date,

neither is affected. Either side could have speculated on more gains (for the producer if price moved up) or lower costs (for the buyer if price moved down), but this way the uncertainty of the outcome is removed for both.

In the previous chapter's political risk example concerning frozen chicken parts, the negative impact on poultry producers wasn't caused by the losses, but by the volume contraction they experienced afterward. At the time the problem occurred, their product was protected from the immediate drop of the prices by forward contracts.

A commodity may vary in quality, grade, and other parameters. In the past, an inspection verifying the compliance with specifications was a mandatory requirement for all trades. However, eventually these variables were standardized, and forward contracts were modified into instruments called *futures contracts*. Futures have become a subject of market speculation like any other tradable instrument. The brokers in *Trading Places* had nothing to do with either production or processing of FCOJ. Instead, they made long and short paper bets based on their "educated" expectations of prices going up or down in the future.

At the same time, futures contracts have become an additional hedging instrument for producers, especially in agriculture. They are used to minimize the negative impact of unexpectedly poor crops. This type of hedging, however, works only if the worsening conditions affect everyone. Let's say a large quantity of the wheat harvest in the United States is destroyed by a massive epidemic. The growers cannot deliver sufficient volumes and make enough money. However, the subsequent shortage of wheat results in the price hike of futures. The profits made on the sale of the hedging contracts make up for the low production revenues.

Foreign Exchange Hedging

Buying and selling products and services overseas frequently results in the necessity of dealing with multiple currencies. Since the euro entered circulation in 2002, the number of currencies with a significant influence on US commerce has dropped. Still, besides the euro, there is the Japanese yen, British pound, Swiss franc, Canadian dollar, and Australian and New Zealand dollars. And formerly confined to mainland China, the very important yuan also entered the international currency trade in 2011.

It is important to understand that dealing with foreign currencies does not automatically expose companies to foreign exchange risks. If an entity can isolate its operations in different currencies one from another, it remains

impervious to any movements on the foreign exchange market. For example, if a part of a company's business is conducted within the European Union (EU) in such a way that it buys materials, pays for labor and services, and sells product in euros, then these European operations have no exposure to exchange rate adjustments.

However, that's not what generally occurs with the majority of small and midsize companies involved in international commerce. The most common case is an importer with payables in foreign currencies and receivables in US dollars. So, let's say your procurement department enters today into a €500,000 purchase contract payable in 90 days on CIF (cost, insurance, and freight) terms, when the product is loaded for shipment. There is only one way to protect this company from foreign exchange risk: to acquire a forward contract to purchase euros on the day the company will need the currency. Just like any other forward hedging, such a contract fixes the quantity (amount of currency) you will receive, the date of the transaction, and the price you will need to pay (the future exchange rate).

■ **Caution** It is mandatory to establish proper communication procedures for the departments responsible for the initiation of transactions that involve foreign currencies. They should check with the treasury function before any commitment is made, so that the exchange rates can be verified and possible profits/losses assessed based on the converted values. Staff should be forewarned of the dangers of exposing the company to foreign exchange risks.

If the currency you need to purchase is on a rising track, it is likely that your future rate will be higher than the current moment's spot rate. (Just like stock prices, currency rates move up and down throughout the day.) On the surface, it is cheaper to buy the currency right away, with a *spot contract*, but that's a bad treasury management move—you cannot sit on the idle sum of money for several months. The only time it makes sense to do that is when the contract's conditions can be negotiated for prepayment with a discount sufficient, together with the currency price gain, to cover the effects of the negative cash flow (the payment before receipts). In situations with declining currency rates, the temptation is always to wait longer before entering into a forward contract, in hopes of even better prices. However, that's speculation, and our purpose is to avoid or minimize uncertainties.

■ **Note** Keep in mind that by fixing the conversion rate, you assign an exact value to the product in question. This way, you level it with all other costs measured in US dollars, and give yourself the benefit of proper pricing, accurate revenue and profitability forecasts, as well as realistic cash flow projections.

Exporters or international distributors who accept payments in local currencies are not common. Most transactions are conducted in dollars and euros. Still it happens from time to time. And in these cases, the principles of hedging the future receivables are exactly the same. This time, however, you must enter into a *forward sale* contract. In this situation, the foreign exchange uncertainty is multiplied by the credit risk. You don't want to find yourself with an open forward contract approaching a due date and no currency on hand to back it up because the customer is late with the payment. Ideally, open-term receivables in foreign currencies should be avoided. When it comes to LCs and bank guarantees, you still should be very careful in estimating the hedging time window, allowing for presentation and processing time.

As discussed in Chapter 20, in order to conduct foreign currency transactions, you need to employ foreign exchange services provided by banks or brokerage houses. Remember that the rates quoted to you will be higher than whatever numbers are published in newspapers or on the Internet, as they will include the service provider's costs.

Interest Rate Hedging

Some may think that interest rate-hedging derivatives do not have much to do with small and midsize companies, but that depends on the industry. In commodity import/export, a company with \$300 million annual sales and 40 employees is considered small. A manufacturer with the same annual volume and 1,000 employees is still a small company. Yet these types of entities are frequently heavily leveraged by multi-million-dollar credit lines, most of them with adjustable interest rates tied to LIBOR or prime, both of which change daily.

If the sums of such floating-rate loans are significant, a company may consider hedging the risk of the soaring cost of money with such instruments as an *interest rate cap*, which sets an upper limit on the interest rate in exchange for an up-front fee, or an *interest rate swap*, which converts a flexible rate into a

fixed one for a period of time. If you are in need of a quick cash influx, you can use a LIBOR-driven loan to enter into an *interest rate floor* derivative, which pays up-front fees for foregoing the benefits of the dropping rates. The most conservative of these derivatives is the *interest rate collar*, which installs both the cap and the floor in such a way that the fees cancel each other, making it a safe and free instrument.

Hymn to Diversification

The very first and most basic advice you'll receive when you plan to invest your savings is to diversify your portfolio. And everyone understands it: the simple rules of statistical probability tell us that if you invest \$10,000 in ten different instruments, it is unlikely that all of them will fail at the same time. On the other hand, if you put the entire sum into one basket, the risk of losing everything is high.

It's simple. Yet, time and again, private business owners and their teams invest money, talent, and effort into a single niche, because it is the most attractive and profitable for the time being. They don't take the conservative (frequently labeled as pessimistic) position that business environments may change at any moment. They forget that concentration is the enemy and that diversification is the only means of survival, especially for small companies. It is the most important preventative strategy when it comes to diminishing commercial risks.

Concentration comes in different forms and shapes, but among the most persistent are the following:

- *Customer concentration:* Some businesses go as far as selling up to 90% of their products or services to one customer, even turning new customers away for the sake of that "most important" one. What they forget is that there is no such a thing as a loyal customer; a new supplier with a lower price may come along and you can say goodbye to your single source of revenue. The larger your customer base, the better chance you have to survive.
- *Sourcing concentration:* Relying on one source of raw materials or products can quickly bring your production or trade to a halt if your commercial partner loses financing, sells its operations, or decides to get out of that business. In some industries, it is difficult to have parallel sources, because they compete against each other. Still, it is highly important to have backups for all resources.

- *Geographical concentration:* It frequently happens in small businesses that due to the management's connections or some temporary economic development in a particular area, the company's sales efforts are focused on a single region. Domestically, such a strategy suffers from possible exposure to changes in local economic conditions. Internationally, a multitude of risks arise, including a decline in demand and political risk. The search for new markets and geographical diversification are crucial survival factors.
- *Product concentration:* It is not easy to constantly develop new products or formulate new services. Yet one-product and one-service companies are the most vulnerable. On the other hand, a company with a long list of marketable offerings can afford to lose one or two, if the demand for them declines for one or another reason. Diversification of revenue-generating channels and attainment of strong positions in new market sectors with complementary products and services is the most important risk-management strategy.

CFOs and controllers don't have to deal with commercial risks alone. Managing these risks should be a collective effort that includes the entire executive team. Procurement, sales, and operations can be both risk-taking and risk-resolution centers. Promoting the cooperation of all parts of the business organism in building a protective shield should be one of the top priorities of the financial executives.

Tax and Regulations Compliance

In his letter to Jean-Baptiste Leroy (November 13, 1789), Renaissance man and Founding Father Benjamin Franklin, with his characteristic wry wit, formulated one of the undeniable truths of human existence: “In this world nothing can be said to be certain, except death and taxes.” Ever since the Egyptians introduced the biennial tax over 5,000 years ago, rulers and governments have been collecting a variety of levies from their subjects and citizens, generating income that sustains the state. Originally, people conducting any sort of business paid appropriate dues as individual taxpayers. The concept of the corporation as an entity that can survive its individual members and thus maintain a going concern indefinitely was formulated in ancient Rome. Since those times, such enterprises have been considered legitimate taxpayers.

In the United States, the authority to collect all taxes, except for tariffs, rested with the state and local governments until the beginning of the 20th century. Several prior attempts by the federal government to impose income taxes on both individuals and business taxpayers were deemed unconstitutional, until the 16th Amendment legalized Congress’s right to levy an income tax. Today, taxes are imposed by all three levels of government.

In its precise definition, the term *corporate tax* refers to an income tax that is applied to an entity's net income, calculated as revenue reduced by all allowable cost and credit deductions. The variety of tax issues affecting businesses and their shareholders is mind-boggling, especially for organizations at a certain level of structural complexity with multistate and international exposure, even if they are relatively small. The intricacies of tax law for acquisitions, consolidations, transfer prices, foreign tax credits, special treatments of certain revenues, and deductions are only a few of the biggest challenges. As of April 18, 2011, the length of the US tax code was 60,000 pages.

Add to this the diversity of state and local corporate tax requirements, plus other categories of business taxation, with industrial and licensing regulations on top, and it becomes clear that a significant level of familiarity with what applies to your company is required in order to prevent exposure to the risks of noncompliance. It's necessary whether you have external advisors or not. You may not need to memorize every single detail of the various laws, but you must have an overall picture in mind.

US business taxes can be divided into the following main groups:

- One group is the already mentioned *corporate taxes*, which on the federal level are based on *net operating income*. This also includes capital gains resulting from the disposition of assets and dividends from investments. Forty-seven states and many localities impose corporate taxes as well. Some of them are applied to the operating income, while others may use asset-based calculations. A state considers a company established under its jurisdiction domestic. A company that was formed elsewhere but does business within the state is considered foreign, and is taxed only on the allocated portion of its business. Entities with multistate presence allocate their income throughout all states where business is conducted. Depending on the state, earning income (selling), owning assets, renting facilities, paying wages, and even holding inventories in third-party warehouses are considered grounds for local taxability.
- *Payroll taxes* are levied on employers under the Federal Insurance Contribution Act (FICA, 7.65%) and the Federal Unemployment Tax Act (FUTA). The effective federal unemployment tax rate is 0.08% on the first \$7,000 earned by each employee. The rest of the unemployment contributions, at various higher percentages and wage bases, are collected by the states. In addition to the taxes due from a company, the employer is responsible for withholding and remitting employees' income taxes and FICA payments.

- *Sales and use taxes* exist only under most state (all but five) and local jurisdictions. Retail sales (i.e., sales for consumption, not resale), and the leasing and rental of many goods and some services are subject to these taxes. The sellers are responsible for charging and remitting the taxes, as well as filing the tax returns. There are three main issues to be considered by any business in relation to the sales tax responsibility: whether the company's products and/or services are taxable, whether the products and/or services are obtained by the final user, and in which states and localities a company can be assumed liable for sales tax collection. The last consideration is especially sensitive today, since many sales are conducted via the Internet. When e-commerce was born, for some time it was assumed to be a no-jurisdiction territory, and whatever you bought online was tax-free. Eventually, the regulations caught up with the issue, and now everyone abides by the same rules. The main determining factor used by the majority of tax authorities is *physical presence*. If you have an office, warehouse, operational location, or any other type of commercial residency in a state, retail purchases there will be taxable. In addition, a company as a consumer is subject to use taxes. For example, if you buy computers in California and have them shipped to New York, the seller does not need to charge you New York's sales taxes if she does not have a physical presence in the state. However, you must report and remit them as use taxes.
- *Excise taxes* are governments' (federal, state, or local) instruments of controlling market demand for specific products or activities. As such, they can be defined in various terms and formulas: per unit of measure, excess of produced quantities, sale price base, and so on. Excise taxes are usually imposed on producers, wholesalers, and retailers. Yet they're considered *indirect taxes*, as they're passed on to the ultimate consumer as a part of the price. The population's alcohol consumption has been one of the main targets of excise taxation in many countries, including the United States, for centuries. Among other domestic examples are tobacco, firearms, communications, air and waterway transportation, fishing, oversized tires and heavy trucks, coal mining, crude oil, aviation fuel, and gasoline.
- *Property taxes* are mostly regulated by jurisdictions below the state level. Only a few states have property taxes. Rules vary from one locality to another. Most frequently, they affect the real estate and

are determined on the basis of fair market value. However, even if your company doesn't own any buildings or land, the application of property taxes to other forms of business property must be investigated. In some cities, rentals above a certain value or inventories held for sale are subject to property taxes.

- *Customs duties* (a.k.a. tariffs) are federal importation taxes imposed on goods brought from foreign countries. Besides being a significant source of the government's revenue, they also act as an efficient instrument of trade control. Thus, the duty rates vary depending not only on the type of product, but from country to country as well. Products from some countries can be brought into the United States duty-free based on various trade agreements. There is also a list of exempt products. Companies engaged in the continuous importation of goods as part of their operations either have in-house customs experts or utilize the services of a broker.

In addition to business taxation, the privilege of conducting certain types of business is regulated through licensing and issuing of special permits. The industry and the locality of operation determine whether you're subject to various requirements imposed at different levels of authority. There are several industries regulated on the federal level: agriculture, alcoholic beverages, firearms, fish and wildlife, maritime transportation, mining and drilling, nuclear energy, radio and TV broadcasting, oversized-load transportation, and logistics. However, the list of industry-wide and narrowly specific licenses and permits imposed by state and local agencies is significantly longer and widely varied, and needs to be thoroughly checked. Some states and municipalities, such as Washington, DC, California, and South Carolina, require all entities to acquire general business licenses in order to be able to operate within the jurisdiction.

Tax evasion and deliberate misstatements on returns are serious offenses and can have criminal consequences, particularly to the owners of closely held corporations. Of course, if you fail to pay importation duties, it automatically arrests your ability to bring your product into the country and leads to numerous problems not only with Customs and Border Protection (CBP), but also with your freighters, customers, and so on. Otherwise, the risks associated with errors or violations of tax laws are primarily related to the heavy financial burdens of penalties. There are basically four types of tax offenses resulting in penalties:

- *Failure to file the tax return by the due date*, which, depending on the type of the return and the locality, could be a flat and fairly

reasonable amount such as \$50 or \$100, or calculated as a percentage of your prior periods' liabilities.

- *Improper filing format*, which is most frequent with large volumes of taxation information—for example, with federal W-2 or 1099 submissions, which are required to be filed electronically via the IRS's Filing Information Returns Electronically (FIRE) system if you have more than 250 forms. If you file paper forms, the penalty is \$100 per each form in excess of 250.
- *Failure to submit payments on time*, which is the most expensive of taxation violations, because the penalties are calculated as percentages of balances owed. The ones associated with corporate and payroll taxes are especially severe, with federal rates of 2 to 10% depending on the time that has passed between the due date and actual payment; some states charge as much as 50%. Payroll taxes that are delinquent beyond the due date of the quarterly return (usually one month after the end of the calendar quarter) may result in business owners' personal liability, which applies to anyone who owns more than 5% of the company's stock.
- *Erroneous returns*, which may or may not go unnoticed. Nowadays, the IRS and state taxation agencies filter all filed returns through electronic systems with preconfigured lists of red flags. And even though top-to-bottom audits are rare, especially when it comes to small companies, individual lines and items are frequently questioned. This may result in the returns' restatements with increased tax liabilities.

On top of penalties, the tax authorities charge interest on all unpaid balances. As of April 2011, the rate was 4%.

■ **Tip** If you have a delinquent bill with any tax authorities and you believe it is incorrect, you should dispute it as soon as possible. If it is correct, it's important to keep communicating with them. If the issue is neglected, they usually act quickly. They have an automatic system of approvals and will execute a bank account lien very fast.

The risks of noncompliance with licensing and permits regulations go beyond just penalties and fines, which are generally (and generously) administered together with time limits for remedying the violations. Authorities

have various means of restricting or prohibiting business operations in case of persistent failure to comply.

Again, I cannot overemphasize the importance of being sufficiently educated about taxation and licensing requirements as they apply to you, and keeping abreast of all changes. As with any information today, it's all about knowing where to begin. If you find a good starting point for research, it will lead you to more and more resources. One of the first well-designed government Internet sites was the IRS's (www.irs.gov), and it's indispensable when it comes to federal taxation information. You can subscribe to IRS Newswire and receive regular e-mail notifications about all new developments, including standard quarterly and annual changes. You can find links to all the state tax sites on the Business tab.

That said, my personal favorite portal into the wealth of information available on the Internet for both business taxation and licensing requirements is the US Small Business Administration site (www.sba.gov). It's organized in a way that eases navigation through all facets of government regulations from start to finish, and includes not only elaborate explanations and forms concerning federal matters, but also links to states' sites that provide information on different aspects of business regulations.

It goes without saying that as soon as your company reaches a certain level of organizational complexity, which translates into taxation or business regulation concerns of higher sophistication, the best approach is to seek advice from the tax division of the CPA firm you use, specialized tax attorneys, and private companies offering licensing support services.

Ensuring Your Going Concern: Strategies, Plans, and Forecasts

It's scary out there. The daily struggle for business survival is getting harder and harder. There are no saved paths, definite possibilities, or guaranteed outcomes. Economic, financial, and commercial environments are constantly changing. The first impulse is to play ostrich—bury your head in the sand of the daily routine and try not to worry about your bottom sticking out into the doubtful future. However, the harshness of the daily reality is the very reason why contemporary CFOs and other senior financial managers cannot afford to act like that. You have to raise yourself above the scope of direct functional responsibilities and define your position from a holistic point of view—as an integral part of the business mechanism. You have to be brave and look forward. Partnering with the CEO/business owner in the process of shaping the company's future became a mandatory job requirement a decade ago. Today we must go further and not just participate and support, but also apply our commercial acumen to formulate

and propose new initiatives. It is a misconception that these tasks belong only to the world of big business. Small and midsize companies are more vulnerable to external impacts and, therefore, in need of even more strategic executive care.

Principles of Strategic Planning

Strategies and *tactics* sound like big words and evoke images of Napoleon and Churchill, or at the very least, long, polished mahogany boardroom tables, but in reality every person strategizes. The *Oxford English Dictionary* defines *strategy* as a plan of action designed to achieve a long-term or overall aim. A 16-year-old high-school student deciding whether to apply to college to study accounting or go to Hollywood in pursuit of an acting career makes a strategic decision that will affect her future. The core logical procedures behind such decision-making apply to any type of critical planning.

In principle, a *business strategy* formulates an organization's path into the future and answers three basic questions:

- What do we need to achieve?
- Where are we right now?
- How are we going to get to the new place?

The task of answering these questions constitutes the process of strategic planning. It can advance in the order outlined above, starting with a concept of the company's ideal positioning that may come from the owner's aspirations, or industry shifts, or some breakthrough development within the company. This leads to the evaluation of the current situation in light of the new objective and appraisal of the gap that needs to be closed to attain new

optimal conditions. Finally, you decide on the proper steps to take and resources to allocate in order to achieve the desired result.

Alternatively, the process can start with the second item on the list—the assessment of the company’s present state. This is a good approach for those entities that have reached a certain point of stagnation that may threaten its ability to keep up with the rest of the business world, or those already experiencing distinct problems. How you interpret the circumstances clarifies the vision of the direction the company needs to go. Finally, the step-by-step method of getting there is devised.

Whichever approach shapes the strategy, the planning methodology consists of the three stages and results in the construction of three components:

- Definition of the strategic goal (a.k.a. vision or mission)
- Detailed description of the company’s status
- Outline of the action plan

A strategic planning committee of a small or midsize company is very different from what it is in a large public enterprise. More frequently than not, it’s just the boss and you. He randomly throws ideas at you whenever they come to him, while you consistently try to formalize the process and bring to the table only well-formulated proposals. Sometimes it’s a good thing and sometimes it’s not. The boss’s brainstorming may be brilliant, but the burden of the subsequent groundwork falls entirely on you. This may stifle your own creativity. Moreover, there may be other people in the company with bright suggestions that never get heard. Ideally, your peers responsible for marketing, operations, and other crucial activities should be involved in the creative process and share the responsibilities of the assessment and planning stages.

When you read books and articles discussing theories of organizational management, there seems to be a strong emphasis on the strategies of growth, advancement, and improvement. “*How to excel?*” is definitely a prevalent question. And it is understandable, because we have come to believe that only a constant movement upward constitutes an accomplishment. Thus, many people associate the very idea of strategic planning with novelty, innovation, expansion, and new frontiers. In reality, such questions as “*How to survive?*” or “*How to maintain?*” are just as crucial and frequently demand elaborate planning.

It is important to remember that strategy development does not necessarily need to be triggered by special circumstances. Actually, it is apparent that those companies that make looking into the future their standard routine

have a far greater chance for longevity and success. The conventional wisdom teaches us that we should prepare for life's possibilities in advance. It applies to business as well. Whether you work for a young company on a fast growth track or for a mature one that reached a plateau, periodic reassessment of objectives is a necessity. There used to be a time when every formal job interview, especially if conducted by a professional recruiter, ended with a standard question: "Where do you see yourself five years from now?" I don't know if prospective employees can look that far ahead nowadays. Nevertheless, a good CFO must—not for her own sake, but for the sake of her employer. *A rolling-forward five-year strategic plan with periodic performance evaluation, reassessment of objectives, and adjustments of related activities is a good practice.*

Theory of Strategic Planning

Theorists of organizational management have been working for decades on formulating methods and developing tools of strategic planning. Since selecting goals and devising specific action plans depend on various factors particular to each individual business, the majority of academic studies concentrate on techniques of business and situation analysis, which are much easier to standardize.

The model that employs the most generalized approach is probably also the best known—*SWOT (strengths, weaknesses, opportunities, and threats) analysis*, credited to Albert Humphrey. It looks at two sets of opposing characteristics and elements:

- Internal:
 - Strengths within the business that give the entity an edge over the competition
 - Weaknesses within the business that put it at a disadvantage
- External:
 - Opportunities opened to the business in the current environment
 - Threats that could prevent business from succeeding

The theoretic value of the SWOT model is rooted in its universality. You can apply it to any type of strategy and use it to evaluate the powers influencing a company's financial plans, market position, distribution prospects, and so on. You can even enrich your hiring process by applying the analysis

to the way you read resumes, turning candidates' qualifications into internal characteristics and your department needs into external factors.

Notice how the model doesn't dictate where and how to look for the individual items of the assessments, giving you freedom to use your creativity and apply it to whatever planning task you need to accomplish. When it comes to external factors, for example, you could include both macro- and microeconomic aspects.

In a very different way, such *environmental scanning frameworks* as PEST (political, economic, social, and technological), EPISTEL (ecological, political, informational, social, technological, economic, and legal), and STEER (socio-cultural, technological, economic, ecological, and regulatory) are used in strategic management for assessment of *specific macro-external factors* that may affect business development. On one hand, the definite composition of these instruments simplifies the appraisal of the outside forces. On the other hand, these tools by themselves are obviously not sufficient for coherent strategic planning, because they leave out the company's internal characteristics.

Another important tool, the *balanced scorecard (BSC)*, takes a completely opposite approach to strategic assessment and considers only the elements directly related to the company's activities. Nevertheless, I consider it to be a unique tool, because it goes beyond situational analysis and combines the ongoing feedback with the impulse for new actions. Its core concept promotes perpetual development of new adjusting and improving strategic steps based on the periodic assessment of the organization's attainment of its mission. Originally developed by independent management consultant Art Schneiderman in 1987, it gained vast popularity in the English-speaking world and Scandinavian countries during the 1990s.

As pictured in Figure 34-1, the BSC breaks down an entity's overall strategy into four separate perspectives: sales and marketing, capital (finance), operations and administration, and organizational development. In each section, the model employs the same structure: formulating strategic purpose, measuring achievements, adjusting and/or expanding new goals, and outlining actions to reach them. As a performance evaluation instrument, the BSC's framework is all about finding the right metrics, creating proper methods of collecting relevant data, and setting the targets that will advance the company toward fulfillment of its mission.

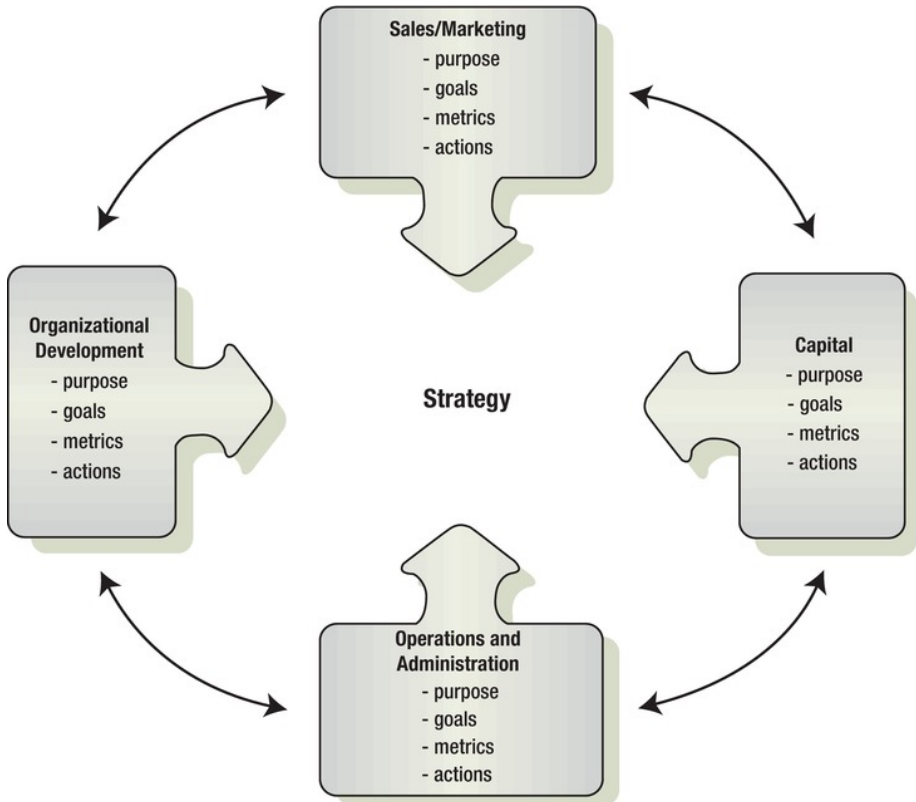


Figure 34-1. An interpretation of the BSC concept

Even though powerful, none of these theoretical methods are 100% perfect. Trying to jam a live business organism into one or another framework without any adjustments and practical considerations would be a mistake.

Practical Applications of Future-Planning Methods

I've come to learn for myself that the best approach is to be flexible and not to stick to one particular standard model or reject another because it doesn't fully apply to your situation. It is important to weigh all shortcomings and drawbacks of each instrument you may use. Assess the applicability of each tool to your particular case and use it as a template. Keep an open mind and find your own combination of the best features of different models.

As I always advise, try to use common sense and digest the best techniques into your own methodology of strategic planning.

The practical value of SWOT analysis, for example, lies in its potential for multipurpose utilization. By identifying strengths, weaknesses, opportunities, and threats possibly affecting a particular strategy, you simultaneously evaluate the viability of its objective: if it is impossible to manage the four forces in order to realistically attain the established goal, you have to go back to the drawing board. Assuming the objective is decided to be feasible, the same characteristics and factors of the current situation can serve as guidelines for developing the steps of the action plan:

- How to match the company's strengths with the opened opportunities?
- What to do to overcome the weaknesses and avoid the threats?

When using environmental scanning analyses, you must remember that the importance of one or another set of factors included in the mix significantly varies from company to company, depending on the industry, locality, market sector, products, and so on. For example, consumer-products companies are always affected by social factors, while food-and-drug manufacturers and distributors, even though targeting consumers as well, place highest priority on the regulatory and legal factors. Remember, no matter how many letters there are in the abbreviations of these instruments, none of them assesses a company's own business characteristics. It is a good idea to use them in combination with SWOT analysis.

When it comes to BSC, most executives and professional management coaches use it in its standard version, as if it were set in stone. However, you can modify the model to fit your needs. A company that depends on the constant introduction of new products and services in order to keep up with technological advancements may consider replacing "organizational development" with "product development." Moreover, it may decide to split the "operations and administration" category into three groups to separate R&D, implementation, and production. A company trading high-demand natural commodities does not necessarily consider a customer policy to be a strategic item, while procurement is highly important. In this case it would be advisable to adjust the model and replace "sales/marketing" with "procurement."

Also, companies frequently utilize this instrument as a narrow performance evaluation mechanism, limiting initiatives to instructions on achieving the set parameters. Some companies even employ this model as criteria for determining the sales commissions. However, you can use BSC as a first step of

the strategic planning process—to evaluate the entity’s business conditions through performance analytics in order to establish new goals and develop an action plan. Don’t forget about the practical drawback of the BSC approach—the fact that it only looks at the internal factors. For the purpose of strategic planning it must be used in combination with one of the environmental scanning analyses, such as PEST or STEER.

Your company’s solution could be as eclectic as it needs to be. For example, after formulating the strategic goal that has a potential to bring about sufficient benefits to justify allocation of various resources, the planning process may follow this sequence of steps:

1. Identify parts of the business crucial for this strategy in BSC’s manner.
2. Determine missions and goals for each part as the subset of the overall goal (BSC).
3. Identify the company’s weaknesses and strengths in terms of accomplishing the goal (SWOT).
4. Perform environmental scanning analysis for those external factors that apply to your company (along the lines of STEER).
5. Identify specific industrial and market barriers and opportunities relevant to your company (SWOT).
6. Develop the action plan, distributing responsibilities and estimating the timeline.
7. Plot the allocation of required resources.
8. Identify the implementation milestones and formulate the performance metrics to measure progress at each stage (BSC).

Get Your Voice Heard

The SOX guidelines for publicly traded corporations demand for a CFO to become an integral part of a strategic planning team. Hence, the big-time chiefs join in, so that yet another item on the compliance list can be checked off. Forget all that if you work for a privately held, especially small, company. Here, the privilege of proposing a new course or even voicing your opinion about the future of the company must be earned with years of dedication and hard work. If you establish yourself as someone with a strong commercial sense and not just a “money person,” it will be easier to get your points

across. Ideally, by the time you are ready to formulate your point of view, your fellow strategists should be prepared for something of value to come off your desk and be interested to hear what you have to say.

If a novel idea about the organization's future has been germinating in your head for a while and you want to present it for consideration, approach this task in the same way you would pitch an entrepreneurial idea to a group of investors. Maybe you don't need to write a 30-page formal business plan, but you definitely must have *well-formulated targets and benefits, sensible justification, obstacles and barriers analysis, and a feasible action plan*. Try to anticipate all possible quizzing directions. It's hard to overcome people's resistance to new suggestions in the first place; don't weaken yourself with unpreparedness. At the very least you should be ready to hand out a comprehensive summary. One possible format is presented in Figure 34-2.

Whether the decision group works on the strategy proposed by you or brought to the table by someone else, or born in a brainstorming session, when it comes to the process of step-by-step planning, a CFO's role is *three-fold*. This is different than the role of any other participant. First of all, as a businessperson a CFO should apply her commercial acumen and evaluate the strategy's application to the entire complex of the company's activities, while at the same time estimating its future benefits. Secondly, a CFO takes on the role of the economist in order to fulfill the requirements for collecting, digesting, and interpreting various positive and negative external factors, forces, and opportunities. Finally, a CFO and her analysts have a unique responsibility to flesh out the proposed action plans by turning descriptions and outlines into numbers. Various projections and models can be built in order to test the strategy's viability, determine missing pieces, optimize resources, and find the best ways to reach the set goals. The next chapter provides highlights of analytical tools that can be utilized in strategic planning.

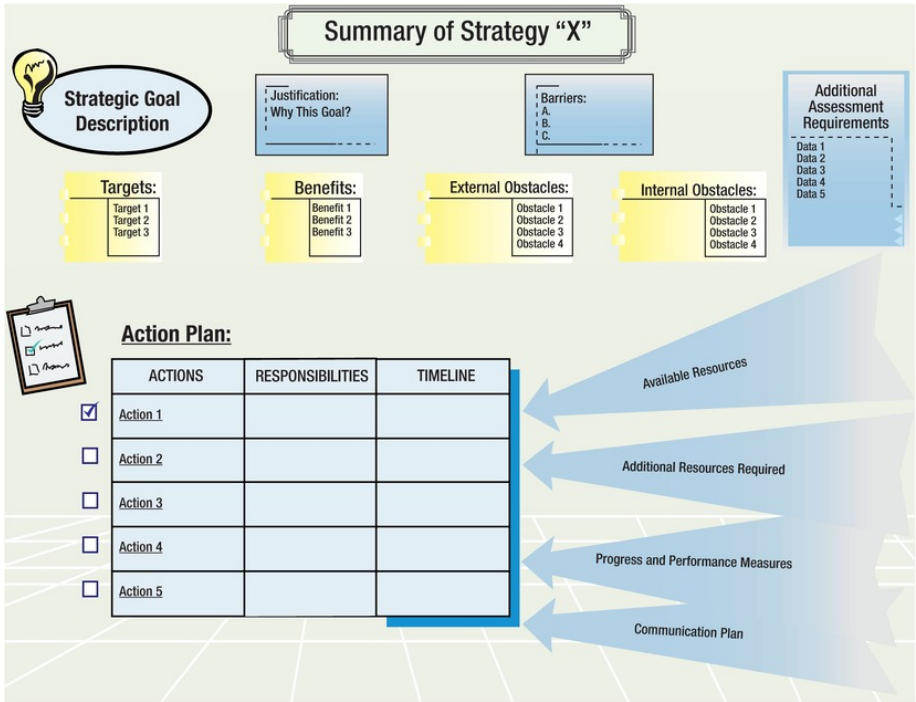


Figure 34-2. Example of strategy planning summary

Practical Modeling and Forecasting

Just like strategies and tactics, modeling and forecasting sound more intimidating than they really are, at least in the realm of small and midsize businesses. Of course, there are uber-complicated models that require super-powerful IBM machines and years of programming. They are primarily related to simulation of large, complex structures and organisms: national and world economies, various markets' processes, or ecological and biological systems. Most Nobel Prize winners in economics achieved their honors by creating models to support their theories on such sophisticated matters as worldwide monetary dynamics, theory of incentives, game theory, optimum allocation of resources, and so forth.

Part of my postgraduate work was developing a cost optimization model for a manufacturing cycle with multiple constraint factors—a system far less complicated than, let's say, the currency market. Still, even with variable factors limited to eight, it was not a trivial task. It took a several-page-long algorithm to describe the sequence of programming instructions to make my calculations automatic.

However, operations and strategic plans of individual businesses are less complicated—describing them in numerical format does not require special programming skills or expensive software. And the only time heavy-duty hardware is utilized is when we deal with very large volumes of data. For example, most companies that rely on call centers and online customer services as

their revenue-generating sources (telemarketers, debt collectors, etc.) believe that the more phone lines they engage, the higher volumes they achieve. (I don't agree with such econometrics, but that's a separate conversation.) A model that reflects this head count–driven revenue notion is a very simple calculation. With only one factor of influence, technically you don't even need a computer; calculate your historical average performance per employee and multiply it by the number of seats you want to fill. However, if you have 90 locations in North America alone with 20 to 200 employees in each location, the volume becomes an issue—you need to start feeding the data into a digital machine and let it make those elementary calculations.

Of course, not all small and midsize business processes and strategies can be described in simplistic ways, but their complexity most definitely does not go beyond the abilities of a seasoned CFO or controller. And at their current level of capabilities, Excel and Access can definitely handle the quantification of most action plans. Moreover, the data pool is manageable within the personal computing environment.

I have a dream that all business strategies pursued by companies in the free-market economy should ultimately target one benefit: the increase of net profit. Not because it would streamline the task of forecasting and modeling, but because, at the end of the day, it is the most important performance indicator—pretty much the only factor that ensures a going concern. In reality, however, plenty of strategic goals are set for other reasons.

Public companies, of course, constantly make moves that impress market analysts and investors, but don't necessarily affect their bottom lines in a positive way. Overhauling executive management is a strategy, and you can definitely model the market's reaction to the change and its effect on the stock prices with a certain accuracy. But nobody seems to care whether it will make the company more profitable. The same is true for young, private companies in hot industries with their eyes on an IPO or a buyout—their business strategies are concentrated on market positioning, so the models are built around volumes and customers' acquisition.

Privately held small businesses in mature industries are more EBITDA oriented; after all, it's the source of the owners' compensation and retained capital. However, even among those entrepreneurs, an ambition to hit the big time frequently overtakes common sense. My advice is to supplement models of any strategic target with profitability estimates. It may actually have a very sobering effect. But before you embark on the task of transforming different parts of an action plan into numbers and mathematical operations, you must figure out whether it's even worth your time. To do that you need to use a cost/benefit analysis.

Cost/Benefit Analysis

Essentially, cost/benefit analysis is a comparative tool. If there are several strategic development projects on the table, you can use it to rank their priority, giving preference to the ones with the potential for the highest contribution to the company's well-being. If it's just one goal, but it can be achieved in different ways, the optimal choice is found through comparison of the cost/benefit profiles of corresponding action plans. And even if it's a single goal with only one possible course of action, there is always the alternative of not pursuing it at all. In this case, the cost/benefit analysis becomes the study of the project's feasibility and justifies its rejection or approval.

Cost/benefit analysis is applicable to any future activity that requires evaluation, because we always expect to derive certain benefits from our decisions, and everything we do has some sort of cost attached to it, even seemingly non-monetary efforts. For example, let's consider HR's strategy to eliminate employees' tardiness by introducing a policy of docking a half-day's vacation time for every incident of lateness. If we disregard the relatively immaterial expense of delivering a warning memo to all employees electronically and posting some notices in the common areas, there seem to be no other costs involved. The company has been using time-clock hardware and software to monitor attendance for a long time anyway. And the benefits are obvious—either the utilization of the working day improves or the company saves money by reducing the paid vacation time. Yet there are far greater costs associated with the implementation of this strategy. Aside from the unaccountable time the employees will spend discussing the “cruel ways of management,” such drastic measures will always result in the deterioration of morale and increased labor turnover, which subsequently leads to additional hiring and training costs, as well as reduction of productivity during the learning period. It is just a matter of putting a number on these consequences.

Actually, *uncovering all possible costs and benefits* of a project and *quantifying* them are the biggest hurdles of a cost/benefit analysis. Most of the cases we deal with in real business life are far more complicated than textbook examples of investing \$50,000 and expecting \$15,000 annual inflows for the next six years. It takes a full understanding of the entire organizational system and an investigative ability to search for every possible negative and positive impact a strategy may have on the entity. Monetizing these factors into cash flows requires the combination of commercial acumen, economic astuteness, and financial expertise. Keep in mind that *cost/benefit analysis is a cash-based method* and never forget the *principle of conservatism*: estimate the inflows on the lower side and the costs on the higher side of the possible ranges.

After you've assigned dollar signs to everything, including handshakes, and gotten all possible outflows and inflows in a row, you must find their common denominator in terms of time, because, as we all know, there is a big difference between today and tomorrow's dollars. The financial notion of *present value* works as such an equalizer. To bring a future cash flow to its present value, we *discount* it using the rate of return that could have been earned in some other way, but in a similar risk environment. It's relatively easy to find such interest equivalent in the investment world, but when it comes to an active business, the complex of risks is difficult to approximate.

I believe that the *company's own weighted average cost of capital* is the most accurate discount rate, at least for the purpose of project evaluation. It fairly reflects the idea that within the company's operational system, the funds must grow sufficiently to cover the financing costs, and the risks are exactly the same. If, for example, the entity's operational capital of \$20 million consists of a \$10 million loan with 5% interest, a \$5 million credit line at 8%, and \$5 million of the firm's own capital with an expected rate of return of 15%, the weighted average cost of capital will be 8.25% annually.

As long as the discount rate i is defined, you can calculate a present value of a cash flow C_t received t periods from now as follows:

$$PV = C_t / (1+i)^t$$

The *net present value (NPV)*, which calculates the present value of the sum of all positive (benefits) and negative (costs) cash flows, is the most popular and most comprehensive cost/benefit indicator. If it's positive, then the project is comparatively favorable. Negative NPV indicates that the costs will outweigh the benefits.

Coming back to our discipline strategy example, let's say that within the next three years the company will succeed in reducing the lateness across the board by 120 minutes a day, which, at the average pay rate of \$20 per hour, will result in annual savings of \$10,400. At 8.25% weighted average cost of capital, the present value of the savings in years one, two, and three, respectively, are \$9,607.39, \$8,875.19, and \$8,198.79, or a total of \$26,681.37. At the same time, the turnover rate has increased and the company lost in each of the three years five, four, and three employees above the historic average. The recruitment cost is approximately \$500 per employee, and the training and adaptation periods with 50% reduction of expected productivity has averaged to 10 weeks (still at \$20 per hour). The present values of these hidden costs amount to \$20,785.22, \$15,360.90, and \$10,642.66 per respective year, or \$46,788.78 total. Thus, the NPV of this seemingly progressive initiative is *negative* \$20,107.41. Definitely a bad idea.

■ **Tip** The utilization of the cost/benefit analysis is not limited to just planning stages. At the start we deal with estimates and assumptions, but after a project is approved and the implementation stages begin, it is advisable to come back to cost/benefit analysis as actual costs are realized. When the goal is reached and all benefits are materialized, you can use the analysis to compare the results with the original expectations, as well as the opportunity cost of foregoing other strategies in favor of the one chosen.

Modeling and Forecasting Simplified

To remove any mystery from the concept of modeling, let me say that it is nothing more than an attempt to represent something through different means. A child uses plastic LEGO pieces and translates buildings, airplanes, and even people into toy representations. Then he plays with them, simulating interactive events. I always say that one of the best modeling tools available to financial professionals is the yellow pad: you can sketch a diagram depicting a business process or ballpark a project's profitability in a manner of minutes. It's not dynamic, but it's still on-the-spot modeling.

Most of the models constructed by financial executives and their analysts during the strategic planning process, though, belong to the category of quantitative (mathematical) modeling. They use variable and constant parameters, and define correlation among them through mathematical concepts and relationships, thus simulating processes within the system. Input variables and constants can be both external and internal factors. Output variables, obtained as the results of the model's mathematical operations, represent strategic goals, objectives, and targets. Unlike strict academic models replicating abstract processes, frameworks reflecting commercial probabilities frequently use subjective information and rely on expert intuition, professional experience, and common sense.

As was mentioned before, in principle, you can turn everything into numbers and translate any business process into a model. Even a vaguely defined strategy such as "improvement of customer service quality" can be broken down into individual tactical activities, such as the implementation of call-monitoring software, periodic review sessions, development of new scripts and protocols, and maybe simply scheduling executive pep talks. All of these steps have obvious and hidden costs associated with them. Benchmark research and expert perception can be used to estimate their incremental benefits and interrelationships with key factors. For example, you can have a

test run of training sessions, using the resulting data of changes in the cancellation rates, numbers of repeat orders, and so on, for modeling the long-term strategic plan.

■ **Note** A meaningful translation of the strategic goals and controlling factors into the numerical parameters and an accurate definition of the correlation among them are the most important aspects of successful modeling. When done correctly, it will guarantee that the resulting model will become a crucial tool in executive decision-making and strategic planning.

Like modeling, forecasting and projecting both attempt to predict events that have not happened yet. However, when it comes to business planning, there is a vital distinction in the perceptive quality of these two methodologies. When we create models of functional systems with a particular achievement in mind, we try to shape the future—we look for the combination of factors that *may* produce the desirable result. Forecasts, on the other hand, are far more focused and deterministic—they usually examine a particular parameter (market demand, prices, currency rates, revenues) at a specific point in time and conclude (with a degree of uncertainty) that this is what *will* happen.

To come up with such conclusions, forecasting methods use various explicit techniques usually divided into several categories and subcategories that can be classified into two broad groups: qualitative and quantitative. The most popular examples of the former are informed opinions (which many business execs give daily without even knowing that they're employing a scientific method), expert judgments, historical analogies, surveys, and the Delphi method (several rounds of questionnaires answered by a panel of experts with a statistical mean or median representing the result).

The quantitative methods, regardless of the variety of mathematical techniques they utilize, all boil down to construction of trends based on the historical data. Decades of development have resulted in a variety of number-grinding formulas and computer programs of various complexities, some even using artificial intelligence technology. Moving average, extrapolation, linear prediction, weighted moving average, and exponential smoothing are the ones that don't require writing computer code, and can be expressed by formulas in an Excel environment. The examples in Figure 35-1 show monthly revenue and gross margin trends developed based on 42 months of historical data using a 12-month weighted moving average formula. With all other commercial factors being equal, it proved to be a fair tool for estimating these indicators for the next 12-month period. The more data is accumulated, the higher accuracy of predictions can be expected.

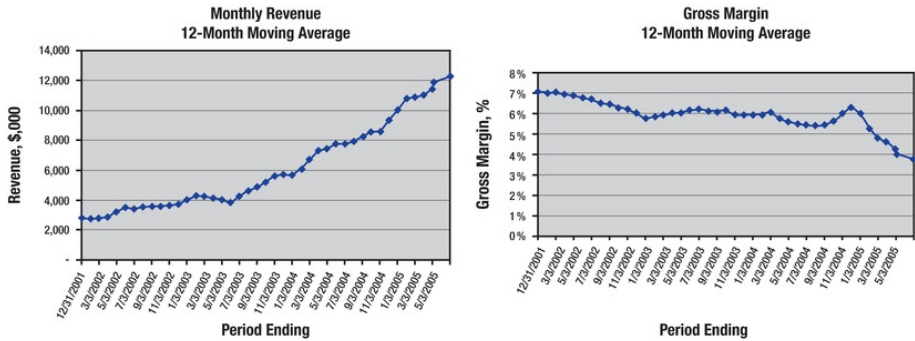


Figure 35-1. Projections of revenue and gross margin trends

In my experience, the synergy of modeling and forecasting methods produces the best strategic planning tools, especially when a model incorporates the time factor. For example, if you are developing a revenue model for rolling out a new product in the next 24 months, you can establish correlation between variable factors in order to achieve monthly goals, while incorporating historical data to predict such external inputs as resource prices, wage and benefit costs dynamics, and so on.

Emphasis on Sensitivity

Regardless of the nature and substance of whatever we attempt to visualize and interpret, one fundamental concept of modeling must be always in the front of our minds: that it replicates a system driven by *variable parameters*. The responsiveness of the objective to the input is the pivotal feature that must be built into every model, so that you can see what kind of results you receive if one, or another, or all of those key factors are changed.

Commonly known as *sensitivity analysis*, this method of creating a construct that responds to changes in inputs by producing different scenarios of results is an integral part of strategic planning. A good model design should reflect this principle both structurally and visually. It is advisable to draw attention to the factors of change and the variations of outcomes they induce in a manner similar to the way it's done in Figure 35-2, which provides an illustration with two simple models of similar design, built for the same strategy (utilization of Internet advertising), but with two different objectives in mind.

The first model reflects an action plan that pursues a goal of increasing revenue by \$6,000,000 annually. Depending on the company's choices of per-click price and the ad placements, which affect the conversion rate (percentage of clicks that translates into customers' acquisitions), the company can

achieve this revenue objective at different costs. By changing the sensitivity variables, you can produce different scenarios of required investments.

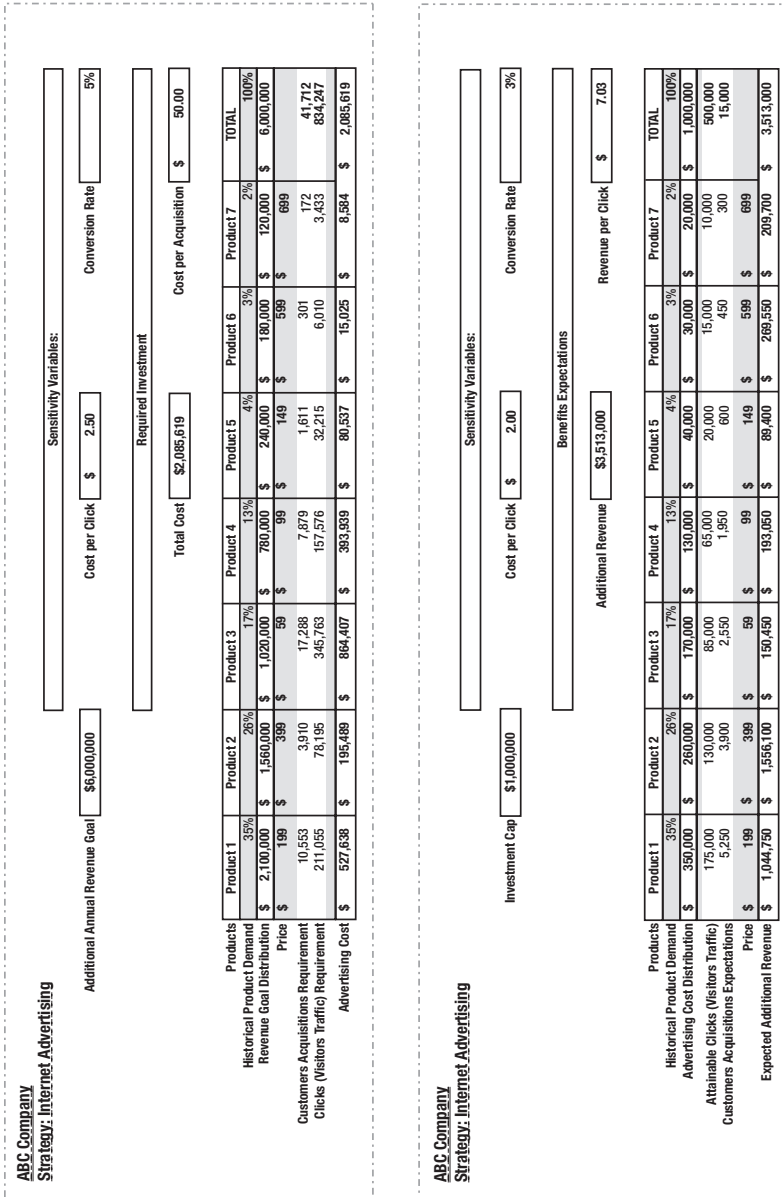


Figure 35-2. Examples of sensitivity analysis models (courtesy of E&D CC)

The second model assumes a limited investment resource with an annual Internet advertising budget capped at \$1 million. In this case, the model is designed to show how much additional revenue such an investment can bring depending on the choices of per-click prices and possible conversion rates. Note that both models incorporate forecasting techniques by extrapolating historical data of demand for various products. An expert judgment is used in assuming that it will hold up with the new form advertising as well.

It's clear that the profitability of the proposed course of action is not addressed in either of the cases. The purpose of the modeling here was to reproduce the correlation between the cost of advertising and the additional revenue benefits depending on several modifying factors. If you want to perform a feasibility test, you need to conduct a cost/benefit analysis. For a more detailed picture you can extend these models to include all components of cost, including new Internet advertising expenses, and see if the additional sales will be profitable.

■ **Note** Of all different personal ideas and observations I share here, this one is probably the most important, and it's only fitting to place it within the part of the book that deals with strategic planning. What separates a truly versatile CFO with expert knowledge of the fundamental principles and a set of easily transferable skills from an average accounting professional is the capacity for conceptual thinking. An ability to see the big picture, recognize similar patterns and hidden relations, apply past knowledge to new situations, identify key differentials and trends—these are the qualities we must cultivate in order to achieve new professional heights. These are not abstract, but rather very practical notions: with suitable variations you can use the same report design for hundreds of different analyses, or the same modeling principles for strategies that seemingly have nothing in common. Instantly recognizing similarities and coming up with solutions make you look almost like a magician, but it's nothing more than hard-earned expertise.

New Ventures

Consider yourself lucky if you work for someone who is dynamic and ambitious, and, more importantly, understands that only the diversification of business opportunities guarantees a company's survival in a volatile economic environment. The strategic plans of enthusiastic entrepreneurs go beyond those that are focused only on necessary internal developments such as operational improvements and marketing undertakings. When a business owner's mind is set on longevity and growth, it is inevitable that the introduction of new products, expansion into related industries, acquisition of competing and complementing companies, and venturing into new commercial territories will be within his business prospects. These new horizons exponentially increase opportunities for a CFO's professional growth, which always comes hand in hand with an increased workload. Even at the planning stages, it requires deeper research, more analysis, and a wider variety of modeling. And that's just the beginning.

A classic example of expansion through diversification is Amazon.com. Launched in 1995 as an online bookstore start-up, little by little the company pursued all venues of growth and development: adding products like CDs and DVDs, already sold by traditional booksellers along with books; going international by buying competing companies in some countries and setting up local versions of Amazon in others; acquiring sites that seemed to be in a different cyber realm, such as IMDb, but turned out to be perfect media for direct links to Amazon's products; creating its own proprietary electronics; and so on. Amazon's visionary founder Jeff Bezos will not hesitate to compete in any market: with Apple in music and video streaming, with eBay as a

consumer products marketplace, or with Groupon on the special deals in your neighborhood.

Of course, the scale of Amazon's success is unprecedented—it grew to be a \$32 billion company. However, there is nothing new about the routes the company took to get there. And there are plenty of small and midsize businesses that, on a more modest scale, assured their stability and prosperity by exploiting one or several of those methods. I hope you get a chance to work for a company that goes through corporate transformations, because it's a very exhilarating experience. But, what happens right after all cost/benefit analyses are done, all possible scenarios are modeled, the action plan is detailed, and the new venture's deal is underway? *In all likelihood, as one of the first steps of the implementation agenda, you will need to either set up a new entity or absorb an existing one into your corporate structure.*

Actually, in case of the absorption typical of merger and acquisition (M&A) transactions, the decisions about the way the entities are combined are usually made during the preliminary negotiations process. At the end they are all formalized by legal agreements. This makes the fulfillment of the structural changes more streamlined. Of course, there is still plenty of work related to setting up operational, functional, communicational, and reporting interactions; policies and procedures; and taxation issues. But the legalization of the establishment will be more mechanistic than intuitive.

■ **Note** In many M&A situations, such as in the Amazon example, you end up with subsidiaries that retain their corporate identities, and sometimes even names, assuming they carry brand-recognition value. However, if the buyer is only interested in assets and/or the operational substance, the acquired company will cease to exist. The departing entity then must get tax authorities clearance by filing all applicable *final tax returns*, submit *articles of dissolution* to the state of its original incorporation, and report *corporate resolution of liquidation* to the IRS.

In many instances, a new venture strategy calls for the creation of an entity from scratch, which means that you have to lay down the corporate foundation before embarking on all those other functional tasks. And this is not necessarily a very complicated exercise, but it is fairly elaborate. Of course, in big companies with large purses, scores of attorneys surround every new deal, and they take care of everything. (This does not guarantee a perfect execution, by the way.) However, in the cost-saving world of smaller entities, many actions can be undertaken by CFOs and their staff, especially

now, when so many formalities can be accomplished online. (Sometimes I stop for a second and remember that less than 15 years ago people still needed to go to city halls to file corporate applications and spend hours on the phone trying to get through to the IRS to obtain an Employer's Identification Number [EIN]. The time consumption terrifies me.) Even if you engage outside help, being aware of the details that comprise the formation and setup of new entities will allow you to monitor the process. The personal participation is very crucial, because this first implementation stage is a combination of decision-making and execution of meticulous routine tasks. These decisions will have an impact on taxation, consolidation, financial reporting, and further strategic moves that may take place in the future.

Checklist for a New Domestic Entity Setup

The following checklist is an outline of basic steps necessary for legitimizing a new business entity into a recognizable and functional artificial being. It's compiled with a generic new venture in mind. The list is based on the assumption that you are starting something that has not existed before. Hence, it begins with the initial steps any new business must take before it starts operating. Depending on your actual situation, you may disregard the items that don't apply. For example, if the new venture involves an existing company, you will obviously want to skip the incorporation steps and pick up from any point after. On the other hand, all internal setups are applicable not only to domestic entities, but to international entities as well. That said, it is impossible to predict all specific circumstances surrounding the birth of a new establishment and cover all possibilities that may arise. Therefore, the list is illustrative, but not exhaustive. As I always advise, one needs to be flexible and use common sense when applying general suggestions to particular situations.

- Establish the preferable entity type: corporation, limited liability corporation (LLC), or limited liability partnership (LLP).
- Clarify the ownership of the new entity: whether it will be a subsidiary owned by the existing company, or a related entity owned by the same shareholders. If outside investors are involved, follow the agreement to identify their percentage of ownership.
- Establish the state of incorporation. It does not necessarily need to be the same as the state where the business operates. However, for tax purposes it will be considered the entity's state of domicile. In all other states it will be considered a foreign entity.

- File a Certificate of Incorporation in the elected state (practically all states have online portals for corporate filings). Note that selecting a unique name will speed up the process of incorporation, as the state will not accept a name that is too similar to one that they already have in their databases.
- Obtain corporate book, seal, and stock certificates.
- Have an attorney draft the bylaws and the corporate charter. Alternatively, you can use reasonably priced services such as LegalZoom to prepare standard corporate documents for you.
- Prepare shareholders' meetings to resolve whatever specific organizational issues must be included in the corporate charter, but first and foremost to elect corporate officers with the signatory rights.
- Note that meeting resolutions become integral parts of bylaws.
- Apply to the IRS online for an EIN (www.irs.gov/businesses).
- Check with the state whether it requires a separate state identification number or charter and apply accordingly.
- Determine the new entity's states and localities of operations, which include all jurisdictions where facilities will be located and employees will be hired, as well as those associated, for example, with opening bank accounts.
- Obtain Certificate of Authority or foreign entity qualifications in all states identified in the previous item, where the entity is considered out-of-state (foreign)—that is, in the jurisdictions other than the state of incorporation (online portals are available in most states). Note that if you incorporate in Delaware, but want to open a business account in New York, a Certificate of Authority will be one of the documents requested by the bank officer.
- Decide whether the entity qualifies and would benefit from a Subchapter S (individual shareholders and estates) or Qualified S (corporate shareholders) designation.
- If required, file IRS form 2553 to elect S corporation status, or form 8860 for qualified Subchapter S subsidiary election. Note that for the election to take effect in the current tax year, these forms must

be filed before March 15; if filed later, the status will take effect only at the beginning of the following year.

- Research federal, state, and local industry regulations, licensing and permit requirements, consumer rights, and fair business practices (see www.sba.gov).
- Apply to obtain applicable licenses.
- Open the new entity's bank account(s).
- Decide whether the payroll will be managed internally or outsourced to ADP, Paychex, or a similar service. Even if you intend to use external services, the next two steps should be completed—if not for payroll, then for business taxes.
- Enroll as an online business taxpayer with the Electronic Federal Tax Payment System (EFTPS) to be ready to start remitting your payroll tax liabilities. Note that the enrollment process requires a valid verifiable bank account, which is why you need to open at least one bank account first.
- Enroll for online tax payments and filings in all states where you plan to employ staff or need to pay business taxes. Note that the enrollment and bank verification time varies from state to state, so it is better to be proactive and not delay this process. Many states make electronic payments mandatory nowadays. The processing delay will not be accepted as an excuse for a late payment/filing, and penalties will be incurred.
- Implement HR policies and procedures, including the selection of benefits.
- If it is not a new manufacturing or retail facility, decide whether the new entity needs a separate space, or will sublease from headquarters.
- If needed, lease operational and/or office space.
- Decide whether the new entity will have access to the headquarters' shared services (including HR, billing, credit and collections, general accounting, legal, IT, customer service, travel and office supplies procurement, etc.), or will be required to set up its own departments to cover the corresponding needs.

- Decide on centralized or decentralized treasury—that is, whether the new entity will be required to remit its collections to the headquarters and either have its payables paid there or receive a periodic allotment to satisfy them, or whether it will manage its cash flows independently.
- If applicable, define the nature of intercompany sales/purchase transactions.
- If applicable, establish transfer pricing; outline billing and payment procedures.
- Identify other possible intercompany transactions (e.g., capital financing) and translate them into recording procedures.
- Establish physical and digital locations of the new entity's books and records. If your operational software can accommodate multiple entities, the company can be set up within the main system. Otherwise, a separate application will be required. In either case, the access will be determined by the decisions above on centralization and shared services.
- Set up the new company in the operating system.
- Set up a chart of accounts accommodating structural and transactional decisions.
- Enter beginning balances for cash and capital accounts.
- Establish control mechanisms: even if the new entity is treasury independent, it is advisable that the executive and financial management is centralized, providing operational guidelines and financial control in order to make sure that the activities do not contradict the overall mission.
- Establish the new entity's operational and fiscal policies, procedures, and internal controls.
- Set up the new entity's budget.
- Establish standards for periodic operational communications on managerial and functional levels.
- Establish standard financial-reporting procedures.
- Establish periodic performance-data flow.

Now the new entity is ready to operate.

Foreign Entity Concerns

Today, for many enterprises of different shapes and sizes, expansion means going abroad. In search of more economic means of conducting business, companies produce, export, import, distribute, and procure raw materials, pre-products, finished goods, labor, and services in foreign countries. Financial executives of companies with various international structures have to deal with a unique complex of issues that, even though they are different depending on the particular country, have certain common attributes.

In some cases, it's not necessary to buy or form a full-fledged overseas entity to accommodate your international needs. If your local interests are primarily of a networking nature—making contacts, finding distribution channels, or coordinating outsourcing efforts—a registered representative office may suffice. However, if a company is involved in any type of operational or commercial transactions in a foreign country, such as manufacturing, purchasing, bringing goods through the border, or selling products or services within its territory, some sort of a corporate presence in that country is most likely an unavoidable requirement.

Establishing foreign entities usually calls for engagement of people with local expertise and extensive knowledge of regulations, especially if you plan on hiring employees. Employment laws are very complicated in most foreign countries, and American companies frequently run up huge fines due to various violations. In some countries, even though you are paying your own employees, salaries and wage taxes must be submitted to an appointed government agency, which then pays the after-tax nets to employees on specific days. In others, a one-year trial period turns into “permanent employment,” assuming you decide to retain an employee. After that threshold, you cannot fire anybody without paying him or her a severance package equal to a full year salary plus benefits, even if there is a legitimate cause. The intricacies of arrangements vary from country to country.

Value-added taxation (VAT) and cross-border commercial relationships within the European Union are the other two major hurdles of conducting business in Europe. Both definitely require significant advisory services and employment of local accountants and tax specialists. At the same time I do recommend that CFOs of companies with international subsidiaries spend some time familiarizing themselves with VAT principles—you cannot effectively manage your foreign counterparts without understanding their basic responsibilities.

With the exception of arts and antiques, exports are generally encouraged by most governments because they positively affect a country's trade balance

and its international economic status. Clearly, imports work in exactly the opposite way, both overseas and in the United States. Customs duties are not the only means of the governments' protectionism. In many countries, a lower scale of importation tariffs is applied to domestic corporations as opposed to foreign companies with local branches. If circumstances permit, this factor frequently provides an incentive to set up a related entity with common ownership or enter a joint venture with a local company rather than creating a 100% owned subsidiary overseas.

The intercompany transactions, which are subject to special consolidation rules between domestic related parties anyway, become an acute issue when foreign entities are involved. International transfer prices are some of the most complicated and ambiguous taxation concerns. In theory, related companies can bill each other at whatever prices they wish to establish, creating a loophole for the manipulation of taxable income on each side of the transaction. Under the Internal Revenue Code, a US exporter selling goods or services to its foreign subsidiary or parent has an opportunity to justify its transfer prices by filing with the IRS an economic review (commonly known as 482 review after the governing law 26 USC 482). Other countries heavily involved in international trade, including China, the United Kingdom, Canada, and India, publish their own regulations on this subject.

There are different ways of ensuring that your foreign operations are compliant with local regulations and function in an optimal business environment that a particular country can provide. Countries in which international enterprises customarily come to incorporate or register their overseas operations—such as Belgium, Switzerland, the Netherlands, the Republic of Ireland, and China—have a well-developed network of consulting and legal companies that perform an array of services—from registration and incorporation to bookkeeping, tax returns preparations, and government filings. If there is nobody in your network that can recommend a service like that, you can find them online, but be cautious—check them out and ask for references.

Already mentioned in Chapter 29's discussion on the selection of auditors, opting for one of the Big Four CPA firms is another good way to gain access to professionals with local knowledge, as they have offices all over the world. They can also assist with the financial reporting hurdles of international consolidations, such as foreign currency translations and adaptation of IFRS by all subsidiaries, which allows unification of the preparation of financial statements.

As I said in the beginning of the chapter, if your employer ventures into new business realms, you will be blessed with incredible opportunities for plunging into seas of new knowledge and professional growth potentials.

Exit Strategies

With the possible exception of blue chips,¹ practically all companies, whether private or public, at one point or another undergo strategic transformations that alter the entity in a cardinal manner. There are numerous possibilities for changes to occur in companies with publicly traded stocks. There are hostile takeovers. Stockholders vote for mergers, acquisitions, restructurings, and divestitures every day. For one reason or another, public stock may lose its value and a company dissolves or gets privatized through equity buyouts.

For the current owners of a small, privately held company, some sort of getaway plan is simply inevitable. They may keep it to themselves, but whether you want to admit it to yourself or not, your bosses have an exit strategy. Successfully implemented growth and expansion tactics could be preparatory steps for making the business an attractive candidate for going public or a sell-off. If cashing out is not in the cards for the owners, eventually they will get to the point when their interests shift to some other endeavor or they want to retire. That usually opens only two possibilities: passing the business to the next generation or dissolving it altogether. And then there is the worst-case scenario—going out of business despite everyone's hardest efforts to survive.

Granted, none of this may happen during your tenure at a particular company, but the probability of a CFO or controller experiencing at least one of

¹ A nickname used on the stock market to describe a public corporation with a worldwide reputation for an ability to equally sustain stable performance during good economic conditions and weather difficult times of recessions. It originates from poker terminology, which assigns the highest value to blue-colored chips.

the exit scenarios in the course of her career is very high, and you should be prepared for it.

Business for Sale

Practically every business owner has this fantasy hidden deep inside—to trade the fruits of his hard labor for a tidy sum and retire to “the islands.” In this direct and pure form, it is a difficult (and for many an impossible) task to accomplish. Disposing of business assets is a fairly straightforward process. It’s not much different than selling stuff on eBay: you describe them, benchmark the price with comparable items on the market, package them, put a pretty bow on top, and announce that these items are for sale. But an entire business is a complex living organism that carries values beyond its plants, equipment, inventory, and receivables. Its true worth is afflicted by the elusive notions of *goodwill* and *future returns*. And, therefore, the concept of “selling business” is broad and may include a variety of different deals and transactions.

Solicitations of public and private equity investments, already discussed in Part 3 as a means of capital resourcing, are sales of business stakes and future gains in exchange for immediate cash, which allow the business to continue operating and expanding. Challenges associated with finding and handling stock markets’ underwriters, hedge funders, and capital backers were detailed in Chapters 12 through 15. It seems reasonable, though, to reiterate here that, with the possible exception of angel and venture capital investments in technology start-ups, it usually takes several years of hard work to prep a company as an attractive public or private investment opportunity. The burden of these labors primarily rests on the shoulders of the company’s financial team, spearheaded by a CFO.

Yet the purpose and outcomes of these deals rarely result in the owners instantaneously cashing out and retiring. IPOs are always complemented with *lock-up agreements*. These are binding legal contracts between underwriters and the company’s insiders (private investors, founders, and other original shareholders) that prevent the latter from selling their stock during a fixed period of time, normally ranging from 180 to 365 days. And who knows what may happen in a year’s time? The memory of the Internet bubble burst, which erased 50% of dot-coms from existence, is still fresh.

When it comes to private equity deals that actually come to fruition, more frequently than not the owners sell out primarily in exchange for the opportunity to continue working hard and survive. Whatever cash funds are involved become the operating capital, while the sellers’ stock ownership is

restructured. Alternatively, the transaction may be designed in such a way that on paper the sellers are paid for their original shares, but the closing conditions require the proceeds to be reinvested in the new stock. The end result is the same: the original owners have a vested interest in the company's success. Ultimately preoccupied with an exit strategy of their own (an IPO or a resale), the backers, in exchange for their money, usually demand that the active CEOs dive straight back into building the revitalized entity's value by having them sign long-term employment agreements.

On the other hand, M&A transactions are principally different. First of all, the role of the buyer is played not by a moneyed individual or a financing organization interested in gainful placement of its money, but by a business keen on expanding its operations and frequently operating in the same or a related market sector. The buyer either becomes the acquired company's parent or absorbs the seller altogether.

For example, on the day this part of the chapter was written, the top M&A deal in the news was the acquisition of a privately held and relatively small Irish cloud-content provider, NewBay, by the maker of BlackBerry—NASDAQ-listed Canadian company Research in Motion (RIM). Considering the nature of the two companies involved, it would be a fair guess to assume that NewBay will become a wholly owned subsidiary of RIM. In contrast, the never-ending movements within the banking industry we've all been observing result in the complete swallowing of the seller by the buyer. Either way, M&A transactions lead to significant restructuring and sometimes complete dismantling of the sold company's infrastructure as dictated by the new owners.

Most acquisitions executed between private companies involve actual cash payments. In the case of a public company's participation, besides cash it can offer as a part of the payment its stock, which has easily identifiable market value. This way, the parent's executives create a stimulus for the newly acquired child's executives to continue building the company's value past the acquisition and drive the share prices up. It is most likely that the price of NewBay, \$100 million according to some analysts, will be paid by RIM as a cash/stock composite.

That said, M&A transactions are the only ones that can result in the outright cashing out by the private stakeholders (both owners and backers). Bloomberg's Global Mergers and Acquisitions Legal Advisory Rankings report for the third quarter of 2011, issued on October 1, 2011, showed that 64.5% of deals constituted company takeovers. Cash was a predominant form of payment, accounting for 69.3% of all transactions. During just that one quarter in North America alone, 3,846 deals were concluded, with the total value of

payments amounting to over \$313 billion. Most of the acquired companies (97%) were small and midsize, with the average deal under \$500 million.

Family Business

Family-owned businesses are frequently based on proudly upheld traditions carried out generation after generation. Business dynasties have been built by humans since the beginnings of time. Children went into trades their fathers inherited from their ancestors as apprentices, because that's what was expected of them, and it gave them an opportunity to make a living. This is how the families of silversmiths, jewelers, welders, textile workers, and farmers were built. That's why even today we still have medical, legal, publishing, and other business clans. Early in the film *The King's Speech*, Prince Albert (Colin Firth) tells King George V (Michael Gambon), "Father, we are not a family, we are a firm." And the king replies, "We're the oldest, most successful corporation in the world and sitting on thrones is our business!"

Keeping the business in family hands is not necessarily a bad thing. A steady supply of power successors sustains, to certain extent, the business's continuity. Only a handful of companies develop to become attractive acquisition targets. The rest must either find other means to survive past the current owners' retirement, or fold. My very first controller position happened to be in a manufacturing company that was a family business in its fourth generation. My boss, who by then was in his 60s, carried a burning grudge against his father for forcing him into running the company. Himself a father of three, he deliberately stayed away from his children's career choices and they all succeeded elsewhere. As a person I support the same principles regarding freedom of choice. Nevertheless, I was sad to lose the job when the company closed after we celebrated the owner's 65th birthday.

I believe that the tightening of the current job market will increase the flow of owners' children into the relative safety of familial enterprises. Many of those kids, who originally might have planned independent careers, will dive under the parental wing instead of competing with their peers for the few positions available for well-educated recent graduates. Some of them will even have business degrees.

Regardless of whether the young ones were prepared for it since childhood or came on board due to the lack of better opportunities, when the old guard exercises the exit strategy and yields power to the next generation, the event constitutes a change of command and further metamorphoses may follow. At least, in the case of a company with a long-held tradition, you

work there knowing that such a change will be coming. Many CFOs and controllers who stay with the same companies for a long time watch their future bosses grow and mature, interacting with them for years. And even if it's unexpected, no changing of the guard happens overnight. You usually do have time to prepare for it.

If you want to stay on the job after your current boss departs, use this time to your advantage by taking on the role of an educator and a hand-holder. This has nothing to do with “sucking up” or lowering yourself to flattery. This is a survival mechanism that takes the form of a proud tutelage. If you want to continue to be instrumental to the endurance of the company under the new executive management, you'd better make sure that the leaders are qualified and that they know where to go for support. This is especially important if you care about the business itself and the people it employs. Moreover, if you do it in a subtle, unobtrusive way, your peers and subordinates will understand that your efforts are directed toward protecting everybody's jobs, not showing off.

Finally, if you are good at it, you may actually succeed in creating excellent executive material capable of further advancing the company's mission. These efforts are especially rewarding when the heir is worthy of the cause—bright and willing to learn and evolve.

Winding Up

I wish that none of my readers ever have to go through the process of closing a business. It's a heartbreaking experience. With the exception of Chapter 7 bankruptcy filings, which are usually employed to liquidate a severely debt-ridden business and thus require the participation of at least one attorney and a judge, most of the time the process of winding the business up, unfortunately, becomes the responsibility of the top financial person in the company.

The need to close a business could derive from the owners' conscious, planned, and well-prepared decision to get out, or from an M&A transaction with an acquiring company only interested in the target's tangible and intangible assets. Or it can be the painful conclusion of a drawn-out battle to survive, tarnished by painful commercial contraction, numerous bouts of layoffs, months and months of stretching payables and dodging creditors, lease-agreement interruptions, abandonment of office equipment, and such similar unpleasantness. Regardless of the reason, it is painful to come to an empty office and administer the last rites to the company that has been your second home for some time. Frequently, there is not even an office to come to anymore, and you have to deal with it from home.

When it comes to small corporations, there are many instances of owners firing everyone and simply walking away from everything, leaving behind entities that still exist on paper and assuming that relatively small unpaid obligations here and there will just dissipate. Frequently it works—if a lawsuit’s costs may exceed the debt, the creditor will just write it off. However, it is highly advisable to take proper steps to officially close the business. The boss’s life does not end there, and it is important to explain to him or to her that it is wise to have a clean slate for future possibilities.

I would suggest that, under more or less optimal circumstances, the following minimum number of actions is required to wind the business up in order to avoid any future automatically generated filing and payment obligations:

1. Create and sign a written agreement, if there is more than one owner (partner), resolving to liquidate the business.
2. Comply with labor laws. Make sure that there are no outstanding wages. Check if your state requires that employees be paid for unused time off. If you have more than 100 employees, the law demands that you notify them of the business closure 60 days in advance. In some states it applies to the smaller businesses as well.
3. Satisfy all payroll-tax obligations and file employment returns explicitly marked as “final” with all federal, state, and local authorities. If some agencies had required you to obtain separate EIN numbers, they need to be revoked. Cancel workers’ compensation insurance.
4. Liquidate remaining business assets, including return of the leased equipment. It is not easy to get rid of office equipment and such things by yourself, but there are specialized services you can use that will take a cut from the proceeds as their fee. Whatever money you can get from it is better than leaving stuff behind and being billed for its removal.
5. Cancel business credit cards as well as services with automatic and monthly billings.
6. Satisfy whatever business debts you can.
7. Cancel all registrations, permits, licenses, and trade names.
8. File the final corporate tax returns with the IRS and state and local jurisdictions, also marking them “final.”
9. File corporate dissolution documents with your state. (This is usually done through the same agency that’s responsible for incorporation of new entities.)

10. After the final tax return is accepted and cleared, cancel the EIN with the IRS—this provides the government with a conclusive notice that the company has discontinued employment activities.
11. Close all bank accounts.
12. Provide the owners with the records reflecting closing procedures. Thankfully, nowadays they can fit on a pocket-size external hard drive and you don't have to ship boxes of papers somewhere.

Face the Reality

And the reality is that any of the exit strategies, not just dissolution, may result in the ending of your term with the company. It's not an absolute certainty, but it's a reasonable possibility. If it happens, remember that it's not a reflection on your performance, loyalty, or the scope of your professional knowledge. Moreover, it will not make much difference that you have treated the business as if it were your own, investing your time and heart in it. It's simply how things work—at the end of the day, you are just an employee and there may be no place for you in the post-conversion stage.

The investment bank's underwriter may demand that a CFO of a public company have an MBA from an Ivy League school to make a good impression in the prospectus. Private equity firms may want someone who they know as their watchful eye. It didn't matter whether Eduardo Saverin was a good CFO or not; Facebook's venture capitalists would have found a way to get rid of him because they were only interested in the idea-generating and code-writing founders like Mark Zuckerberg. When companies are absorbed by their new parents after M&A transactions are concluded, many positions become redundant—there could be only one CFO, controller, COO, or CIO in a centralized corporate structure. And who knows, maybe your boss's son promised his wife that she could be the CFO as soon as he took over.

The issue is that, when it comes to exit situations, a CFO or controller's position is probably the most difficult one. Regardless of the personal prospects resulting from the upcoming changes, our fiduciary duties obligate us to do our best and make it happen for our bosses. When I personally had to go through the business-closing process, I couldn't start looking for the next job even with the full knowledge that the current one was about to be over—loyalty prevailed and I still worked until 8:00 p.m. without a break on the very last day.

It's tough and I can only offer a few items of practical advice. First of all, tastefully network as much as discretion allows without being pushy. In today's

working environment, this is important for any job, under any circumstances. Stay in touch with your external contacts and let them know that you are open to new opportunities. LinkedIn has grown into a real international outlet for professional connections. I know it's a lottery, but you never know what may happen.

Secondly, don't burn any bridges. When employments end, the emotions are usually raw on all sides—you have to exercise incredible restraint not to fall into outright hostility. Try to preserve as much civility as the other people will allow you (it's not always just up to you). Ask for reference letters. It's sort of an old-fashioned tool, but the truth is, in a privately held company, a top financial executive reports only to owners. So, when you are asked to provide “supervisor” references, you will need to put down the contact information for your former presidents and CEOs, who are always busy or difficult to reach, or don't want to be bothered. Then the letters will come in handy.

Most importantly, no matter what the circumstances are, work hard and display your best strategic abilities and professional skills—not for anybody else, but for the sake of your own dignity and self-respect.

Administration: The Organization of People

Many functions discussed so far are essential parts of business administration and organizational management: development of policies and procedures, enforcement of performance criteria, planning, controlling, and so on. Managing human resources, both as a set of routine tasks and as a process of dealing with actual people, is probably the most idiosyncratic of job requirements for financial executives. We try very hard to stay within the comfort zone of accounting principles and financial concepts, abstracting the labor units and titles on organizational charts from the individuals they represent. Yet the impact of the human factor on the company's activities is too significant to ignore. So, in order to succeed in this functional realm we have no choice but to summon the most diverse complex of abilities: practical expertise, specialized knowledge, psychological acumen, behavioral awareness, and people skills.

Acquisition of Human Resources

The challenges associated with tasks essential to the administration of HR are reflected in the multiple meanings of the term itself. From an operational and monetary standpoint, labor is a resource not much different from capital or equipment, but its quality may be somewhat unpredictable. Its proper maintenance depends on expensive and time-consuming nurturing. At the same time, the individual units of this resource constitute the substance of the organizational structure and, as such, require efficient placement, streamlining, and coordination. It's a regulated commodity governed by labor laws and the taxation code. Yet, up close, a company's employees are unique human beings with their personal traits, quirks, backgrounds, home lives, and so on.

For a CFO or a controller, HR has an additional dimension. On one hand, HR management is an organizational function, with company-wide policies and tasks related to payroll, benefits, incentives, reprimands, and so on. Today, it frequently falls within the financial executives' scope of responsibilities. On the other hand, as a supervisor you are ultimately in charge of acquiring, maintaining, training, and managing members of departments and groups under your command—your direct and indirect reports.

One way to tackle the obvious complexity of the matter within the limits of a single book section is to select key functional aspects and address them in

a structural manner. Generally speaking, any operational resource, before being converted into a company's final product, passes through two stages: procurement and utilization. Accordingly, this chapter deals with acquisition of HR. The next chapter will outline those important facets of HR functional management that can impact the effectiveness of its usage. Finally, I cannot leave the people factor out of the discussion, and have to give some space in the last chapter to the behavioral side of a CFO's job, interpreting HR as human relations.

Procurement Practices

If we take into account the full spectrum of possibilities, a business can fulfill its labor needs in different ways. Phil Knight, the cofounder and chairman of Nike, is considered to be a pioneer of Asian *outsourcing* (he started in Indonesia). Since the company was founded in 1964, not a single pair of the famous sneakers has been produced in the United States. It was as if he had rediscovered the Orient and opened the door for manufacturers of all calibers into a source of labor with a price tag adjusted to exotic workday standards and cost of living.

Manufacturing labor was only the beginning. Rapid developments in communication technologies opened opportunities for the cost-saving outsourcing of labor-intensive services with easily scripted routines: telemarketing, customer service, technical support, and debt collection. In turn, the technological advancements required enormous amounts of programming and web designing, creating a window of opportunity for utilization of foreign high-tech services. Then followed large-volume billing processing, bookkeeping, and so on. Today, a virtual-company scenario with an idea-generating entrepreneur managing all his outsourced operational and overhead labor from his home office is a conceivable reality.

Companies looking for exceptional sets of skills difficult to find locally (e.g., a combination of US taxation expertise with fluent Japanese) may engage in *importing of labor resources* from other countries by providing foreign nationals with employment sponsorships secured by H-1B work visas. From time to time, the national job market experiences severe shortages of workers in a particular profession. The deficit of nursing professionals, for instance, consistently affects the health industry. During the Internet bubble at the end of 1990s, a similar situation presented itself with the insufficient availability of programmers and web designers. These conditions are usually remedied by the government issuing additional allotments of work visas with specific occupational criteria.

Even without going abroad, companies have various opportunities to efficiently satisfy their labor needs. *Temporary employees* can close interim gaps in required skills or provide reinforcement for fixed-term projects. Moreover, essentially all businesses practice what I call functional *outsourcing* when they opt for engaging services of external providers instead of hiring an in-house specialist to cover a specific area of expertise. For example, only larger enterprises have a need for and can afford in-house counsel. Instead, most companies have relationships with law firms that provide them with advice whenever the need arises. The same is true for IT administration—it makes more sense to sign an annual support contract with a service provider prepared to address whatever tasks may arise than hoping that the problem will fall within an internal employee’s breadth of knowledge.

Business owners and managers should recognize the value of this pattern and try to utilize it in less obvious areas as well. Programming a relatively small but helpful tool for the automatic uploading of time card data into the payroll module does not call for hiring a full-time database specialist. There are plenty of small and large firms that can send somebody to execute this task. Similarly, when a company finds itself desperate for executive reporting and performance analytics, CEOs and CFOs are frequently tempted to replace their good, but somewhat limited, controllers and accounting managers with ones who possess more diverse experience. Usually, such persons come with higher salary demands. However, as soon as all creative work is accomplished, they settle into performing routine tasks. A more sensible way of approaching this situation would be to hire an outside service for the development and implementation of the analytical instruments that subsequently can be utilized by the existent staff. At the end of the day, it’s cheaper to pay a higher contract rate on a short-term basis than take on a salaried employee that you cannot properly utilize full-time.

Still, for small and midsize companies in many industries, “permanent” hiring of salaried employees continues to be the predominant mode of acquiring HR. I’ve used quotation marks because, under the prevailing practices of at-will employment, nobody is permanently attached to his job. The distinction between permanent and temporary employment refers more to a position itself rather than the status of the employee within an organization. Thus, “permanent job” signifies a role that is necessary for the business’s functioning unless economic conditions force layoffs or the company undergoes restructuring. People filling the permanent positions may come and go of their own accord or be replaced by the management.

The Search Process

The adepts of social networking frequently talk about its impact on the employment market, but no matter how vast your web of connections, it cannot possibly access millions of people on a job hunt. And we cannot argue with the rules of statistical probability: the larger your selection pool, the higher your chances of finding the right person. *Talent search* is a time-consuming and difficult task. It does not require special training (most finance and accounting headhunters are CPAs), but its success definitely depends on a combination of practical know-how and a certain knack for picking the good melon, so to speak.

This does not mean that you must resort to using employment agencies just because they are full of people who do this job for a living. There are several reasons for staying away from that option. First of all, I don't know who nowadays can afford to pay 15 to 30% of a hired person's annual compensation in recruitment fees. It's a taxing proposition even for a large corporation, but for small and midsize companies it's an unacceptable expense.

Secondly, the recruitment industry itself has undergone a lot of changes. In an effort to cut their own head counts and improve margins, agencies have computerized practically their entire resume-combing process by employing automated applicant tracking systems (ATSs). This software crunches thousands of resumes, searching not for achievements and accomplishments, but for a combination of words selected by people who don't know anything about your business. Human touch is reserved exclusively for those who match the algorithms, leaving behind talented people who just used different words to describe their experience.

Finally, the variety of user-friendly and comprehensive products available to employers on the Internet at very reasonable rates renders the professional headhunter nearly obsolete. You just need to familiarize yourself with the spectrum of possibilities and tailor a search campaign that suits your needs. Simply put, tools for compiling a selection pool fall into two categories: a passive publicizing of job openings, and an active search for suitable candidates among those who make their availability openly known. Depending on their disposition, some hirers use either or both approaches.

Posting jobs is essentially advertising, and today it is not limited just to well-known boards such as Monster, CareerBuilder, and TheLadders, where you can list an opening at a flat fee for a certain period of time. There are two other major players in employment publicity worthy to be explored. LinkedIn, the worldwide professional network with over 120 million members,

offers strategic placement of recruitment ads in its individual, group, and corporate profile pages as one of its “Corporate Recruiting Solutions.” Of course, if you are determined to go beyond the confines of a particular site, Google AdWords pretty much dominates online advertising and gives you an opportunity to have your ads appear anywhere on the Internet through association of the relevant content.

It is important to understand that all of these outlets are essentially search engines, and therefore, the composition of your postings plays a crucial role in the efficiency of this recruitment method. Search engine optimization (SEO) is the most important aspect of Internet exposure, and it relies exclusively on the selection of the right keywords. These words must respond to job seekers’ inquiries on specific sites, as well as tag your ads to appropriate pages on the Web.

I personally, however, prefer the active mode of searching through candidates’ publicized resumes made possible by such products as Monster’s Power Resume Search, CareerBuilder’s resume database access, and LinkedIn’s unlimited recruitment search. Instead of leaving the application choice up to the candidate, this method provides an employer with the possibility of making her own decisions about whom to contact. This way you also exclude solicitations of professional headhunters, as well as applications from those people who forward their resumes en masse without reading job descriptions. You can customize the search criteria to be as narrow or as broad as you need in order to yield the results that closely match your requirements.

Unless you are looking for an incredibly unique combination of skills, the passive posting will produce hundreds of applications. Even with a well-defined and smartly keyed active search, each opening will result in a significant number of resumes that will need to be reviewed. For larger companies and those with high rates of labor turnover, it makes sense to have an in-house hiring specialist who can take on the responsibility of initial screening. Businesses with occasional recruitment needs may consider functional outsourcing and engage an HR consultant on a short-term basis.

Yet, in the majority of small and midsize companies, staffing is entirely the responsibility of functional executives. You can help yourself by delegating the preliminary work to one of your junior employees. To preserve fairness, the task should be *to score* rather than *to eliminate*. You can compile a list of keywords to look for in the resumes and assign the priority scores to each of them. Don’t limit the list to ten words—it should be sufficiently broad. Your employee’s assignment is to analyze each resume highlighting all the words from the list (this is important, because you will want to see them too) and adding up their priority scores. On your side, you can have a preliminary-

round minimum score number that will allow you to make the first cut. If you actually work on the list and come up with sensible criteria for the items that are crucial for the job, your second round will be significantly less taxing.

The Interviewing Process

Eventually, reviewing yields the top resumes. People behind these papers become the initial group of candidates qualified for interviewing. The intricacies of a job interview have been analyzed many times over by HR professionals, behaviorists, psychologists, and sociologists. They have written volumes and volumes on the subject. I am more concerned with the logistics of the process, because it's my experience that many managers are not aware of the most effective elimination steps that may lead to better-informed hiring decisions. Here is a suggestion for a five-stage selection process.

1. Since emailing has become a predominant mode of recruitment communications, it provides employers with an excellent opportunity for the first round of contacts. Compose *three questions* you would like the candidates to answer in writing. These inquiries should be relevant to the position and fairly specific. Your purpose here is to test each applicant's interpretation of the job's key responsibilities. I strongly advise to state the word count limit: on one hand, you don't have time to read long essays; on the other hand, if you expect at least 200 words per answer and receive one sentence, that will make your position clear.
2. The second round is the *phone interview*. The hardest part of this step is the time limit. The optimal length is considered to be 15 minutes, but my personal experience shows that it's not only difficult to keep the interviewee from nervous rambling, but it's also not easy for the interviewer to stay the course. The key is preparedness. Many people make the mistake of going over past jobs on the phone—this can be left for the personal interview. Instead, you should address the candidate's few specific qualifications and ask precise questions that could be answered in a few sentences. One of my favorite phone inquiries is asking to describe one most important accomplishment.
3. The *first personal interview* must be all about the candidate. The role of the interviewer should be limited to guiding the prospective employee's description of his background, past employment, and expertise highlights with as few questions as possible. Listen and absorb

your impressions. At this point you may also want to assess if the person in front of you is a proactive and eager professional—ask if he has looked up your company on the Internet and what he found out.

4. In recruitment practices, *testing* is usually reserved to either entry-level employees or those whose duties involve particular skills, like writing macros in Excel, or performing translations from Serbian to Farsi. However, I believe that appropriate tests can be designed for everybody—even executive-level applicants. It's not necessary to announce it as a test, and you can try to make it appear to be a natural phase of the interviewing process. For example, while looking for my own replacement at one point, I gave candidates one of the KPI reports and asked them what they derived from it, and where, in their opinion, the data came from. The answers don't need to be 100% right, but the intellectual process can reveal volumes about the person's aptitude for excelling at the job.
5. During the *second interview*, you can let yourself talk more, outlining the company's business and detailing specifics of the job. At this point, you need to look for the candidate's understanding of what is expected of her. It's your job to make sure that, if the offer is made, the position is accepted consciously.

It's quite frequent that, in their eagerness to get the job on one side and to finally fill the position on the other, neither the candidate nor the employer goes past the compensation discussion and into the details of employment conditions, such as working hours, benefits, and so on. That's a big mistake that may lead to unpleasant surprises and discontent later on. It's a good idea to have a written summary of these details, so that it can be attached to the job offer.

What Am I Really Looking For?

Clearly, recruiting people to whom you will delegate functions, for which you are ultimately responsible, is an excruciatingly difficult and demanding task. Even in the buyer's market it's hard to find good candidates. And that's just a start. After hiring, you have to ease the new employee into his functions, fill him with missing knowledge, and perfect his ability to perform the tasks (i.e., develop your new staff member into an asset).

Unfortunately, what frequently happens is that after spending your precious time looking through resumes and interviewing candidates, all you want is to remove the recruitment issue from your agenda. As a result, you

cave in and make the mistake of hiring the wrong person simply because you are tired of the process, and you waste the entire effort. Such failure is damaging to the company, to your own success, and to your staff's morale. That is why it is crucial to define your own criteria of "quality hire."

When it comes to the general parameters, I am actually very flexible. I don't hold industry-specific experience in much regard. As a matter of fact, I believe in the benefits of diversity. Those workers who have exposed themselves to a variety of industrial and organizational specifics usually have deeper understanding of business, sharper commercial acumen, and the ability to adapt to any new circumstances. I also believe that the quality of education depends on the person, not the school—the university's tier is never my concern.

What I am looking for, first and foremost, is the spark in the eyes, the sign of intelligence that you cannot fake. I search for people capable of systematic thinking—the ones that can be given explanations pertaining to one problem and later independently apply the new knowledge to a different task. I seek those who consciously make an effort to build a platform of fundamental knowledge that allows them to create a set of flexible, transferable skills. These kinds of candidates are hard to come by, but they are there, and you can find them if you take the search seriously.

Managing Human Resources

As discussed in Chapter 6, the legal and factual aspects of the HR function are usually summarized in the employee handbook. This document formalizes the relationship between a corporate entity and people that comprise its labor force. It usually consists of general policies and rules that define the company's conduct with respect to its employees and vice versa: how people are hired, compensated, and terminated; how the company complies with labor laws and OSHA regulations; how the employees should treat the company's property, their responsibilities, each other, and so on.

The quintessential tasks and procedures associated with the recording of HR activities and the processing of payroll transactions were detailed in Chapter 8. And the business's obligations with respect to employment taxation were addressed in Chapter 33.

However, these mechanistic topics do not exhaust the extent of HR management in its broader sense—as a function that deals with the effective utilization of a valuable resource in the business process. The labor force consists of various people separated from each other by their own personal ambitions and needs. Yet, together they must be integrated into a system focused on facilitation of the employer's strategic goals. An ability to bond disparate individuals into a collective power distinguishes true managerial talent. Achieving such unification requires a combination of considerable efforts in the organization, development, and retention of employees.

Organizing Human Resources

In my experience, many workers confuse the employer's rationale for hiring them with their own reasons for seeking employment. Businesses don't employ people to pay them salaries, so that they can put food on their families' tables and pay rents and mortgages. It is actually the other way around: if a company could sustain its existence without tasks performed by one or another employee, it would do so and save the money paid as compensation. But it is crucial for the company that the jobs are done, and with sufficient quality, and that is why it retains employees.

There is a reason we call payments received from employment *earnings*—they are to be earned. The successful fulfillment of functions, essential to operational process, by a competent person compensated for his efforts, constitutes the basis of workforce utilization. Understanding that they come to work to earn their wages by doing their jobs well changes employees' perspectives regarding their daily activities. It is the managers' job to show their subordinates that the company's growth coincides with their personal interests, that the company's prosperity will benefit them materially and provide them with a sense of self-worth. To facilitate the effective labor utilization that leads to high-performance results, managers must organize people and tasks in the most efficient way.

■ **Note** While attending to organizational matters, don't forget that you are not an outsider, but an integral part of the system as well. You have your own functions and relations to other team members (i.e., other units of labors to incorporate into the working organism).

The first step of departmental organization is the creation of a logical *structure that accommodates functional processes*. In accounting and finance, the basic structuring occurs naturally because tasks can be grouped into distinct cycles: billing, AR, AP, payroll, treasury, general accounting, and so on. With small departments consisting of three to five people, the exercise never extends beyond this elemental level. Organizing a larger staff with an elaborate division of labor is a more demanding undertaking. At the very least it involves the following activities:

- Defining the *scope of responsibilities* for each position, *assigning specific tasks* to individual employees, and providing them with corresponding *timelines* and *schedules*.

- Establishing *procedural interrelations* among employees to complete functional cycles.
 - Coordinating individual employees into an *integrated framework* that ensures the efficiency of the entire department.
 - Designating clear *subordination chains*.
 - Creating precise *absence relief* arrangements to ensure that all crucial tasks are covered in case one or another staff member is away from the office.
 - Implementing *control* and *status-update mechanisms*, including periodic activities reports (daily, weekly, etc.).
 - Setting sensible *communication* channels and protocols.
-

■ **Note** In small businesses with flat organizational structures, we frequently deal with the absence of middle management, or with situations in which a higher-level employee single-handedly covers the entire function. An AP manager, taking care of all related tasks, from entering vouchers to paying bills and dealing with vendors, is a common position. Still, some supervisory layers may be introduced. A strong accounting manager with general accounting and reporting responsibilities, for instance, can devote some of his time to directing AP and AR functions.

Of all the complexities of administrative function, the most difficult task, in my opinion, is finding *the right fit between an employee and a job*. It is an intuitive process that requires a general understanding of human nature and thorough knowledge of your staff. Pay attention and study the people who work for you. What motivates them? Do they know their jobs well? Do they dread certain assignments? What do they do best? Which projects cause them to procrastinate? Are their duties properly matched with their abilities? It is rarely possible to create perfect combinations, especially if you are limited by the size of your staff, but you can try to do your best. For example, if you have a choice, don't assign AR collections to an introverted person with analytical aptitude—it would be painful and unproductive. Being mindful of employees' capabilities will give you a chance to exponentially increase the efficiency of your departments.

In a fast-paced, intense environment of small and midsize businesses, *communication* concerns are not limited to decisions about what information goes to whom, when, and in what format. People's proximity to each other instinctively encourages direct contact. At the same time, everybody is

usually preoccupied with his or her own work, so a single conversation feels like a significant interruption. It's not surprising that the accessibility of CFOs and controllers is an acute HR issue. Because many of us are so busy, we are perceived to be unapproachable, and that, unfortunately, results in employees' avoiding addressing vital problems with us.

I keep my door open and my subordinates see me all day long attending to my scheduled tasks, addressing issues, and solving problems. I am consumed by work. Yet, every time one of them needs me and comes to my door, they ask me the same question, "Are you busy right now?" Of course I am busy, but it doesn't mean that I am not available to discuss their problem immediately, if it's of high priority. Or, if not, scheduling them for a later time slot. At staff meetings, I teach them to approach this situation in a more sensible manner: come, state your issue, and let me decide if it requires immediate attention. I also initiate everyone into my personal protocol that ranks communication modes against urgency of the issue:

- Low-level urgency calls for an e-mail. It doesn't immediately interrupt whatever I am doing and gives me an opportunity to attend to the problem when I have time.
- Moderate urgency can still be accommodated by an e-mail, but it needs to come with a red flag, signifying its importance, and the word *urgent* in the subject field.
- High urgency warrants the use of an instant messenger, which I can see right away, but can answer whenever I am able to do so.
- When an issue is super-urgent, it's OK to pick up the phone seeking an instant response.
- Only a fire that requires my unique firefighting skills justifies walking over and demanding my prompt attention.

Speaking of staff meetings, many small-business CFOs and controllers forego these important means of assessing the department's status just because they see and talk to practically all employees on a daily basis. This is a mistake. Regularly scheduled and properly conducted meetings, with every member of the staff present, formalize your agendas and give a different perspective to even the most ordinary issues. Moreover, they provide great opportunities for observations of the group's dynamics.

One of the most important factors of successful organizational management, *delegation*, is, unfortunately, one of the least developed skills among financial managers of small and midsize businesses. There are legitimate reasons for that. Great delegators are not born, they are made. Unfortunately, I have not seen a delegation course featured in any business school's curriculum. There

are organizational management courses, but these are primarily devoted to structures and general leadership formulas. It is my opinion that the propensity for effective delegation can be developed only through on-the-job observation or self-education. It is easier to find a good reference point among many managers of a large organization. But if you have devoted your career to small entrepreneurial companies, it's hard to come by a skillful touchstone.

Yet, delegation is a mandatory instrument in a financial executive's daily operations. Mathematical rules of optimization and circus performances teach us that there is a limit to the number of items you can juggle at the same time without dropping them. So, let me offer my suggestions with respect to delegation:

- Your highest priority should be to attend to the tasks that will facilitate the achievement of your company's mission—the ones that require your own unique, complex blend of expertise and abilities that cannot be found elsewhere within the organization. Hence, micro-management is an enemy of business advancement and your individual progress.
- Don't delegate the tasks that you don't like, but only those that can be adequately performed by your subordinates. Especially at the beginning, take into account the task's time constraints—make sure to provide the employees with timelines that accommodate their working pace and the possibility of redoing the job if it's not done properly on the first try.
- At the same time, never perform your subordinate's job just because you believe that you can do it faster and better. This is a bad mistake many of us make. When we do that, we damage ourselves in two ways: by wasting our own valuable time and by not letting our subordinates improve.
- Don't hesitate to delegate important functions to capable subordinates because you are afraid that they will undercut you. If you are a good match for your position and do your job to the best of your abilities, you should be confident. Secondly, by overwhelming yourself with extra tasks, you diminish your own efficiency and undermine yourself.
- Remember, shifting the decision-making down the line to your subordinates does not relieve you of the ultimate responsibility for the delegated work. You are accountable for everything that is done in your department(s). Therefore, before the task is delegated, make sure that it does not fall through the network of internal controls.

It took me a while to formulate these ideas for myself and even longer to start implementing them, but I can vouch for their effectiveness.

Development and Evaluation

As important as delegation is, it cannot be implemented if you are not absolutely sure that the transferred tasks will be performed well. That is why it must go hand in hand with the staff's development and training. Unlike a large corporation with its specially designed improvement programs and coaching seminars, most small and midsize companies rely on senior management for employees' basic training, as well as their professional advancement. Even though it takes time, raising the level of the staff's expertise greatly benefits CFOs and controllers. Not only because it makes delegation of duties possible, but also because it affects the overall performance quality and departmental efficiency.

Some years ago I had a problem with a new employee with a worse-than-moderate learning curve. My boss asked, "Why don't you come with him on Saturday and spend a day teaching?" I recall thinking that it was not fair for me to spend my day off on this slow-starter. But at the end, a full day of instructions and demonstrations, without the mayhem of workday disturbances, was a much shorter effort than all those long after-work hours spent correcting his mistakes. Always make time for training and advancement of your subordinates. By building strong and reliable accounting/finance staff, you better your own chances for success.

Recently, the corporate accounting profession has experienced a strange phenomenon that has made training and on-the-job education especially important. There were times not long ago when in order to "work in accounting" you had to have some formal knowledge of accounting rules. When one dealt with manual journals, and subsidiary and general ledgers, at minimum he had to understand the principles of double-bookkeeping. Technological advancements and computerization have changed all that. Now, anyone who knows some Excel, is quick to grasp menu-driven applications, and displays aptitude for basic math, is good enough to be employed in one or another accounting department.

I know a CFO who took a position at a national law firm. The composition of the accounting-and-finance department she has inherited was as follows: an AP manager with no college degree and 20 years of experience paying bills, a payroll manager with a BS in business administration and prior experience in office management, one junior accountant with a BA in psychology

and another one with a BA in special education. They were smart and hardworking people who mechanically performed their routines as per the software operating manual without any understanding of fundamental accounting principles. Problems arose every time they encountered something more sophisticated than entering an invoice or cutting a check. To improve the quality of their performance, the CFO ended up having individual sessions with each employee dedicated to explanations of the accounting theories behind the functions they performed.

One of the most important catalysts for the improvement of a person's work performance is the understanding of the organization's mission, its commercial scope, and the structure of the value chain, as well as understanding of his own place in the big picture. It seems like a simple idea, but it's not always easy to achieve in—what is typical for small businesses—a need-to-know culture. It frequently becomes our responsibility to explain to our bosses the unfortunate effects of the employees' disconnect from the company's purpose—mechanistic, disinterested performance instead of meaningful, productive work. Don't hesitate to address this issue. You will be wasting your time trying to teach your employees how to apply their expertise and education to the tasks you need them to perform if they are not aware of their relevance to the company's prosperity, and consequently their own.

Our efforts to raise the quality of HR may or may not result in improvements. Whether the outcome is positive or negative, it needs to be measured, evaluated, and acknowledged, which in itself becomes a part of educational process for employees and managers alike. In a sense, when it comes to evaluating their subordinates' performance, financial executives have a head start on other managers. That's because they already have in place a system of internal controls mandatory for monitoring the accuracy and integrity of accounting and financial procedures. The detection of errors, omissions, and improprieties is a good starting point in assessing the value of HR. The impressions you collect through daily interactions form your overall judgment of the staff's proficiency. Most of the time, when a problem occurs, we address it with the responsible employee right away. Sporadically, we find a moment to express our appreciation of a job well done. For many small and midsize companies, those may be good enough HR actions.

Still, I believe that, regardless of the organization's size, formal periodic (quarterly or annual) *performance reviews*, addressing employees strengths, accomplishments, improvements in technical and communication skills, accuracy, integrity, enthusiasm, and so on, are important milestones of each person's evaluation as a company's asset. These orderly assessments, summarized in detailed documents, require the manager to rationally process

her thoughts and render a reasonable opinion. They carry far more value for both the employer and the employee than a reprimand or praise issued in passing. They also provide a justifiable basis for promotions and raises.

Many CFOs and controllers subconsciously resist the idea of initiating confrontational situations and either avoid performance assessments altogether or, in larger companies, delegate it to the HR department. Of course, this tendency wouldn't present itself if all employees deserved glowing reviews, but it's not always the case. There are people who underperform and some of them are not capable of constructively accepting suggestions for improvement. We deal with defensiveness and rationalization (a.k.a. making excuses) all the time. Some people become defensive at the slightest hint of criticism. Nevertheless, you should not hide from your responsibilities. What you can do is explain to defensive employees that their attitudes make them more vulnerable and expose their insecurities; that they need to be stronger and try to make the best of the critical suggestions.

Employee Retention

If you don't remember it, go back to Chapter 3 and take another look at Maslow's Hierarchy of Needs. Sustenance and shelter constitute the basis of human motivation for working. We cannot deny the fact that *wages and bonuses* will always be the main factor in our efforts to retain the best employees. That's why I never believe it when applicants say that it's not about the salary for them. Let's be real—maybe taking a job is not all about the salary, but compensation is definitely the primary consideration. I believe that, within the budget constraints, the good employees should be rewarded at competitive rates in accordance with their worth to the company, and every year I try my hardest to make it happen for those subordinates who are crucial to operational efficiency.

Benefits, too, play an important role in efforts for retaining quality employees. Unfortunately, it gets more and more difficult to assemble a good package. I've been working with the same broker for nearly ten years now, and every year, when the time to renew the health insurance policies comes and I complain about 15 to 20% rate hikes, he says the same thing: "They are not going to go down, and the coverage will only get narrower." And it's not just health premiums; all rates go up—disability, long-term care, and life-insurance policies. Most small companies' profit margins don't have room to offer employees anything beyond basic health insurance.

Nevertheless, there are ways to expand benefits offerings at a relatively low cost. For example, even if the company is not willing to match employees'

contribution to a qualified pension plan, simply having such a plan in place at the cost of a few hundred dollars of monthly maintenance fees gives people a significant tax-saving advantage. The same is true for contributions into flexible spending plans designated to out-of-pocket medical and transportation expenses. In recognition of the fact that employees frequently use sick days for other purposes, many companies are switching to a more progressive paid-time-off (PTO) concept, which combines the conventional categories of vacation, sick, and personal days into one pool, allowing workers to use their free time as they see fit. At the end of the day, the more benefits and perks you can fit into the budget, the lower turnover rates you can attain.

Material stimuli aside, nurturing employees heavily depends on the *working environment*. Creating an atmosphere conducive to high levels of productivity and healthy morale doesn't mean striving for warm, cozy, and family-like ambience, in which principles of subordination get blurred and negligence is forgiven. It means building an environment of objectivity, merit, and fairness. The work ethics of the supervisor herself play a big part in this process. As long as employees know that you set high standards for yourself, they will accept the same requirements applied to their own performance. Knowing that you will appraise their work objectively, they will not be apprehensive, but rather concerned about disappointing you with poor execution of their tasks.

In such an environment, *moral incentives* start playing a more significant role in employees' retention. Approval and recognition of one's success lead to an enhanced sense of self-esteem, which becomes an important factor in a person's attachment to the source of such self-actualization. That said, we must be realistic about the possibility that our efforts to create the optimal working conditions could be stunted by sometimes abrasive attitudes of CEOs/business owners. However, if you can install yourself as a sort of a buffer between the boss and the employees, you might be able to absorb most of the harshness and preserve the goodwill you strain to establish.

The Behavioral Approach

It's only fitting to finish this book with a chapter devoted to a topic that not only permeates all functions of financial and accounting management, but also is relevant to everything we do inside and outside of our workplaces. The subject of human interactions goes far beyond the limits of HR management in its conventional definition. The ability to deal with various categories of people, handle different personality types, adapt your communication style to particular circumstances, and, in the process, achieve your intended purposes—these are critical faculties of any notable person, not just a successful CFO or controller.

Many advertisements for financial executives' positions list "excellent communication skills" as one of the job requirements. In many cases it's just a figure of speech copied from some template. In others, it's a deliberate statement, but it can have diverse meanings: proficiency in written and verbal expression, ability to adapt to the new environment, a team player's attitude, salesmanship, aptitude for influencing people, and even general likeability. In my opinion, all these skills are consequences of one fundamental prerequisite for establishing a successful human connection: knowing your audience. And to know people, you have to study them.

The behavioral approach is based on the concept of explaining behavior through objective observation. Its application to human relations in general and to HR

management in particular can be interpreted as analysis of people's actions in order to identify their unique behavior patterns to better understand their personalities, motivations, priorities, strengths, and weaknesses.

Behavioral assessment is one of the most important professional skills a successful executive must develop and continuously improve. When dealing with your bankers, lawyers, auditors, peers, employees, and bosses, you should be able to gather insights into who they are, explain reasons behind their conduct, and anticipate their reactions. Only then can you take the full advantage of the communication process and successfully realize your intentions. Understanding the person on the other side of the conversation always gives you the upper hand.

Of course, the depth and the scope of the perceptive method's application needs to be adapted depending on the categories of people with whom we come in touch throughout our daily routines. Personality profiling may not be necessary for finding the right key to a successful collaboration with external contacts. Such broad notions as enthusiastic or disinterested, friendly or brash, dynamic or passive, and so on, may suffice. However, a thorough understanding of the person's position within her organization, and of her responsibilities and ambitions, is very valuable.

If you know the person's priorities with respect to your company, you can emphasize the corresponding benefits you can offer. For example, if your bank officer is inclined to expand your credit line, but asks for more transparency, it should be clear to you that he needs something to support his case in front of the credit committee, because his reputation is at stake in case of default. You can help his case and yours by offering, let's say, annual bank audits. The insights into your direct counterpart's standpoint can also help you to stop yourself from using undue pressure in a situation where the outcome is beyond his power, thus helping maintain a good relationship.

When it comes to our *lateral peers*, simple logic would dictate that, since we are all in the same boat, we should always put our differences aside and harmoniously row forward for the sake of everyone's well-being. But it would be naive to believe that all people are capable of doing so. Because departmental managers feel that they are on an equal footing with each other, the behavioral guards are frequently weakened—this is the level of office interactions where the majority of personality clashes occur. The competitive nature of our culture has taught us to vie for first place since nursery school, and it is difficult for us to shake it off even in the face of issues that must be resolved in a collegial manner. The reason there is so much motivational material devoted to the importance of the teamwork around us is because people constantly need to be reminded about its benefits.

Executive peers bicker over all kinds of issues. Whose function is more important? Whose idea is worth pursuing? Whose idea was it in the first place to do something that turned out to be a success? Why did that department get a bigger budget than this one? And everyone's fighting for the boss's ear. What we must recognize is that it's an unfortunate waste of productive time, because sooner or later everyone must reconcile and cooperate. Even if you cannot extinguish the fire, at least don't fuel it by perpetuating the argument, whatever it might concern.

In these situations, understanding the reasons behind your coworker's aggressive attitude may help alleviate recurring problems. One of the most typical sources of controversy is someone whose desire to be appreciated has turned into uncontrollable attention-seeking behavior. A person like that would not stop at anything in order to put himself in the spotlight, including taking credit for other people's ideas. Let's say it happened to you—you worked on a project very hard and now somebody claims it as his original concept. My advice: Don't argue. Instead, start asking detailed questions. Even better, suggest that they should spearhead the further development. See what happens. In fact, clever exposure of improprieties is a good instrument for ending inappropriate behavioral patterns.

Being a boss is a stressful position—a frequent source of anxiety and frustration. In *The Imperfectionists* (The Dial Press, 2010), a novel composed as a psychological study of people connected to each other through their employment by a small English-language newspaper published in Europe, author Tom Rachman allots a separate chapter to the CFO. At one point the writer catches her with this thought: "As she closes her glass office door . . . a few staffers glance over, then look away. It's strange to be the boss, knowing they discuss you, doubt you, resent you, and . . . complain, bitch, and moan about you." This is an excellent insight by an aware supervisor.

The very acknowledgment of people's reaction to you is the first step toward more adequate management. Why does this person act this way? Is it me? Do I need to adjust my attitude? Or maybe it has nothing to do with me. Why does this analyst, every time I talk to him, get defensive without any reason? What motivates this functional group manager to be here an hour before everyone else? You cannot be oblivious to these things and must try to make logical connections.

Chapter 9 defined the human factor as the weakest link in the procedural flow due to people's propensity for inaccuracy and inconsistency. Paradoxically, intellectual flexibility and critical reasoning also makes capable people the most valuable assets of any enterprise. It took generations of computing

science's evolution and nearly five years of IBM's focused experimentation, with a price tag of over \$100 million, to build a single computer, Watson, that could replicate a human's congenital ability of processing natural language. And it doesn't even venture into the territories of subtext and sarcasm. The unique mental facilities of our employees cannot be imitated by any computers. We should be able to utilize their strengths in the most beneficial way. If you pay attention and observe carefully, you will succeed in isolating people's best abilities and analyze their motivations for acting in the particular ways they do.

Knowing your employees' most prominent characteristics and understanding their internal priorities gives you an undeniable managerial edge and allows you to optimize their performance efficiency. When a perfectionist under your supervision starts acting like an irritable child, ask yourself whether his drive for the highest possible quality conflicts with the deadline imposed on him. And if an enthusiastic and talented employee, who just finished developing and implementing an important analytical tool, starts displaying passive-aggressive symptoms, see if you can give him a midterm performance evaluation and express your appreciation. When you are attuned to nuances like that, noticing and correcting them don't require a lot of effort. But leave them unattended and they may cultivate negativity that will challenge the balance of the entire department.

When we are on the opposite side of the relationship, as subordinates whose work is surveyed by bosses, we are presented with a different set of challenges. Not only is the polarity of the dynamic reversed, but also people above CFOs and controllers, especially in privately held companies, frequently represent the ultimate power within the corporate realms. Dealing with them requires special consideration and savvy. The intense responsibility of guarding the personal wallet of a private owner who works in the office a few steps down from your own escalates the pressure and affects the relationship with that individual. It is not the same when the company's owners are unknown mutual fund investors and your boss is an employee, just like you.

Collectively, entrepreneurs constitute a very special type of people with distinct common characteristics. First of all, they take risks that result in the creation of jobs. They've got to be incredibly brave to go out in the world and implement their ideas, sometimes against all odds. If they succeed, they build companies that not only create products and services, but they also employ people and pay them salaries, including CFOs, controllers, and financial directors—that is, us.

Secondly, many of them possess untamed idea-generating minds that propel forward ahead of everybody and everything else. They want new tasks to be finished yesterday and consider those who bring up such practical considerations as implementation timelines and the development of structures to be obstacles on their way to success. There are psychological studies proving that a “perfect entrepreneur” must possess a complex of somewhat erratic personality traits.¹ CFOs and controllers—frequently those who voice reasonable concerns—should be aware that they might be perceived as negative, uncooperative, and difficult. You can prevent possible future confrontations by establishing open lines of communication. But don’t wait for the boss to analyze your behavior. Such efforts may be beyond his sphere of interest. It’s your responsibility to persistently clarify to him what motivates you in these situations—your own drive to do the job right and make sure that the back office, finances, procedures, and controls can support his vision.

■ **Note** Never cross the subordination line with your boss—regardless of how like-minded he and you are, how friendly and good-natured his attitude toward you is, how well you understand his thought process, or how precisely you can anticipate his reactions. Familiarity and disrespect have destroyed many excellent work relationships.

Most professional aptitude tests contain a question about the subject’s preferences on working with others or alone. The complexity of a financial executive’s job invalidates the relevance of such inquiry. Whatever your personal preferences were at some point, if you want to succeed as a CFO, a controller, a financial director, or an accounting manager, you must learn to adapt, seamlessly switching from toiling alone after-hours in the empty office on internal controls to giving a presentation in front of the bank’s credit committee; or from mapping out the cash flow optimization to participating in a heated brainstorming session with your strategy-developing peers. Such flexibility is basic to the job’s essence. Even if you feel most comfortable working with numbers on your computer screen, you end up spending a lot of time in one-on-one and group communication sessions.

As with every function, task, and issue discussed in this book, the best way to achieve proficiency in the techniques of human interaction is *to combine*

¹ David Segal, “Just Manic Enough: Seeking Perfect Entrepreneurs,” *New York Times*, September 18, 2010.

the understanding of fundamental theoretical principles with acute awareness of specific context, quick reaction to any situational changes, and an inquisitive attitude that leads to acquisition of new knowledge. This formula is not complicated, but it is very powerful. Absorb it into your professional philosophy, and it will amplify your ability to excel.

I

Index

A

A&E, 120

Accounting, accrual basis of, 233

Accounting cycles

- and structure of financial statements, 239–244
- balance sheets, 241–242
- income statements, 242–244
- with trial balance (summa summarium), 23

Accounting/finance manager, 10–11

Accounting firm selection criteria, 251–256

- business sector specialization, 253–254
- financial statements' users, acceptability to, 254–255
- geographical exposure, 254
- price, 255
- purpose, 252–253
- quality control, 255–256
- reputation, 254

Accounting management, 23–24

Accounting modules, quality of, 188

Accounting principles, 232–234

- conservatism, 233
- economic entity, 232
- full disclosure, 233

- going concern, 233
- historical cost, 233
- matching, 233–234
- materiality, 233
- monetary unit, 232
- recognition, 233
- time period, 232

Accounting Principles Board (1959–1973), 236

Accounting systems, cash forecasts by, 151–152

Accounts payable, 57–58, 156

Accuracy, 66

- in information processing, 48–49

ACH. See Automatic Clearing House

ACI. See American Credit Indemnity

Active Network, The, 116

Activity-based costing (ABC) model, 217

Ad hoc reporting, 223–228

- due diligence processes, 225
- features, 223–224
- financial leader, key attributes, 224
- inventory dynamics report, 226
- three-year supplier analysis, 227

Adjustment rules, 249–250

Administrative policies, 41

ADP, 180, 311

- Aggregate annual budget, 78
 - for manufacturing/trading companies, 81
 - AICPA. *See* American Institute of Certified Public Accountants
 - Aka tariffs, 282
 - Allocation principle, 217
 - Amazon.com, 307
 - American Credit Indemnity (ACI), 164
 - American Express OPEN, 178
 - American Institute of Certified Public Accountants (AICPA), 35, 236
 - Angel investments vs venture capital, 98–99, 126–127
 - Angelsoft, 127
 - Apple, 307
 - Applicant tracking systems (ATSs), 328
 - Arbus, Diane, 154
 - Asian outsourcing, 326
 - Aspirations, of CFO, 16–19
 - CEO, freeing, 16–17
 - prioritization rules, 19
 - professional growth, 18
 - role, transformation, 17–18
 - time organization, 19
 - Asset-based lending, 105–107
 - Asset-heavy balance sheets, 118
 - Assets, 241
 - ATSs. *See* Applicant tracking systems
 - Audit's timing, 257–258
 - Auditing standards, 258
 - Auditors, 251–256
 - accounting accuracy and completeness, 260
 - accounting firm selection criteria, 251–256
 - business sector specialization, 253–254
 - financial statements' users, acceptability to, 254–255
 - geographical exposure, 254
 - price, 255
 - purpose, 252–253
 - quality control, 255–256
 - reputation, 254
 - auditing standards, 258
 - independent accounting firm, 256
 - welcoming, 261
 - Audits, 23–24, *See also* Fast and painless audits
 - Authorization, in information processing, 47
 - Authorize.net, 178
 - Automatic Clearing House (ACH), 176
 - Axapta, 193
- ## B
- Backers, 98
 - Bad debts, 169, 272
 - Balanced scorecard (BSC), 290–292
 - Balance sheets, 241–242, 247
 - Bank borrowing base (BBB), 133
 - Banker(s), 137–138
 - Banker's acceptances (BAs), 109
 - Banking, 59–60
 - and capital resources, 22
 - Bank of America Merrill Lynch, 176
 - Bank references, 167
 - BAs. *See* Banker's acceptances
 - BBB. *See* Bank borrowing base
 - Behavioral approach, 343–348
 - behavioral assessment, 344
 - excellent communication skills, 343
 - lateral peers, 344
 - objective observation, 343
 - perfect entrepreneur, 347
 - Benchmark research, 301
 - Bezos, Jeff, 307
 - Bill-approval procedures, implementation of, 87

- Blue chips, 315
 - Bond market, 103
 - Bonds, issuance of, 103
 - Bonuses. *See* Commissions
 - Borrowing vs. sales, 110–111
 - Bottom-line policies, 40, 41, 85
 - Brand financing, 112
 - Bravo, 120
 - Break-even revenues, 217
 - BSC. *See* Balanced scorecard
 - Budget(s), 75
 - aggregate annual budget, 78
 - for manufacturing/trading companies, 81
 - contradictions of, 78
 - control, 80
 - controlling, 78
 - as control mechanism, 77–83
 - detailed monthly budget, 78
 - for technology/service companies, 83
 - origination of, 77
 - planning, 78
 - traditional budget, 79
 - Business
 - facing reality, 321–322
 - family business, 318–319
 - policies
 - finance and administration, 40–41
 - operations, 39–40
 - selling, 316–318
 - winding up, 319–321
 - Business assets, disposing of, 316
 - Business cards, 179
 - Business intelligence, 203, 204
 - Business interruption insurance, 267
 - Business nature vs. financial resources, 113–122
 - construction company, 117–118
 - content producers and distributors, 120–121
 - correlation matrix, 115
 - information, 121
 - logistics company, 119–120
 - manufacturing company, 117–118
 - mining company, 117–118
 - real estate and other rentals, 122
 - services, 122
 - Trading Company, 119
 - utilities, 117–118
 - Business Plan Pro, 126
 - Business sector specialization, 253–254
 - Business strategy, 287
 - Business Week*, 127
- ## C
- Capital financing, 95–112
 - debt financing, 102–110
 - asset-based lending, 105–107
 - commercial credit facilities, 103–105
 - corporate bonds, 103
 - trade finance, 107–110
 - equity investments, 96–101
 - founders' investments and company's own capital, 100–101
 - private equity, 98–100
 - public equity, 97–98
 - financial interests, sales of, 110–111
 - factoring, 110–111
 - forfeiting, 111
 - financing disguised as revenue, 111–112
 - Capital resources, and banking, 22
 - CareerBuilder, 328
 - Cash flow projection(s), 145–152
 - cash forecasts, 151–152
 - elements of, 149–150
 - layout, 146–147
 - business complexity, 146
 - business nature, 146
 - commercial tactics, 147

- Cash flow projection(s) (*continued*)
 - layout (*continued*)
 - credit terms and payment forms, 147
 - maturity stage, 146
 - outside financing, 146
 - principle of conservatism, 150–151
 - purpose, 145
 - structural concerns, 145–150
- Cash flow statement, 245–250
 - direct method of, 247
 - financing activities, 246
 - indirect method of, 247
 - investing activities, 246
 - non-cash items in, 250
 - operating activities, 246
 - purpose of, 246
- Cash forecasts, by accounting systems, 151–152
- Cash management, 22
- Cash position, 153–159
 - reports, 155–159
- CB Insights, 127, 128
- CBP. See Customs and Border Protection
- CEO. See Chief executive officer
- Certificate of Authority, 310
- Certified Public Accountants (CPAs), 251
- CFO. See Chief Financial Officer
- Chase Paymentech, 178
- Check 21 law, 177
- Chief executive officer (CEO), 12
- Chief Financial Officer (CFO), 15–19
 - accounting and financial structure, 31
 - aspirations, 16–19
 - CEO, freeing, 16–17
 - prioritization rules, 19
 - professional growth, 18
 - role, transformation, 17–18
 - time organization, 19
 - and controller(s), 18
 - employee handbooks, 37
 - mission, 16
 - responsibilities of, 12–13
 - role, 293–294
- CIF. See Cost, insurance, and freight
- CIT Group, 111
- Citi, 175
- Clean books and compliant statements, 231–237
 - fundamentals, 232–234
 - Incoterms, 234–235
 - regulations, 235–237
- Cloud technology and SaaS, 192
- Coface Group, 164
- Cognos 8 BI, 200
- COGS. See Cost of goods sold
- Commerce, controlling, 85–91
 - commissions, 90–91
 - cost center control, 86–88
 - transactional profitability control, 88–90
 - best point of control, determination of, 88–89
 - control procedure, 90
 - profitability calculation, 89–90
 - profit criteria, establishment of, 90
- Commercial automobile insurance, 266
- Commercial credit facilities, 103–105
- Commercial documents, 109
- Commercial enterprise, 85
- Commercial risks, 271–278
 - diversification, 277–278
 - hedging, 272–277
 - commodity hedging, 273–274
 - foreign exchange hedging, 274–276
 - interest rate hedging, 276–277
- Commissions, 90–91
- Committee on Accounting Procedures (1936–1959), 236

- Commodity hedging, 273–274
 - Common-sense tests, 68–71
 - Company performance reviews, 75
 - Completeness, 66, 72–73
 - in information processing, 47–48
 - Compliance, 66
 - Computer safety policy, 50
 - Concentration, 277–278
 - Conservatism, principle of, 150–151, 233, 272
 - Content producers and distributors, 120–121
 - Control accounts vs. transactional totals, 71–72
 - Controller(s), 11–12
 - and CFO, 18
 - employee handbooks, 37
 - in large companies, 11
 - in start-up company, 11
 - responsibilities, 11
 - Control procedure, defining and implementing, 90
 - Control processes, 21–22
 - Corporate bonds, 103
 - Corporate Recruiting Solutions, 329
 - Corporate structure, study of, 28–29
 - Corporate tax, 280
 - Cost, insurance, and freight (CIF), 275
 - Cost/benefit analysis, 299–300
 - Cost center control, 86–88
 - Cost drivers, 218
 - Cost of goods sold (COGS), 240
 - Covenants and utilization compliance, 136–137
 - CPAs. *See* Certified Public Accountants
 - Credit application procedure, 164
 - Credit approval procedure, 54–55
 - Credit facility, cost structure of, 104
 - Credit insurance coverage, EIN for, 164–166
 - Credit line renewal, 138
 - Credit lines with monthly reporting, 133–136
 - Credit monitoring and collections, 168–169
 - Credit payables, 170–171
 - Credit receivables, 161, 163–170
 - delinquency, dealing with, 169–170
 - extending credit, 164–168
 - bank references, 167
 - company's ownership structure, 167–168
 - D-U-N-S Number, 166–167
 - EIN for credit insurance coverage, 164–166
 - trade references, 167
 - ongoing credit monitoring and collections, 168–169
 - Credit sales, recording of, 233
 - Credit Score Class, 166
 - Crime insurance, 268
 - Cross-border commercial relationships, 313
 - Cross tabulation, 197
 - Currency trading, 180
 - Current assets, 241
 - Current liabilities, 241
 - Customer concentration, 277
 - Customs and Border Protection (CBP), 282
 - Customs duties, 282, 314
 - Cutoff tests, 73–74
- ## D
- D&B. *See* Dun & Bradstreet
 - Dashboard
 - monthly sales, 212
 - and visualization concerns, 209–213

Database management, 192
 Data exportability, 189–190
 Data recovery, 49–51
 Data warehousing, 190
 Debt financing, 102–110
 asset-based lending, 105–107
 commercial credit facilities, 103–105
 corporate bonds, 103
 trade finance, 107–110
 Delaware, 310
 Delegation, 336, 337
 Delinquency, dealing with, 169–170
 Demand deposit account services, 174–176
 Detailed monthly budget, 78, 83
 Direct method, of cash flow statement, 247
 Director(s)
 of accounting/finance, 11
 in Europe, 11
 and officers insurance, 269
 in United States, 11
 Discount rates, 111
 Distressed business investment, 100
 Diversification, 277–278
 Documentary collection process, 109
 Documentation committee, 62
 Documenting procedures, 61–62
 Double-entry bookkeeping, 23
 Due diligence
 of lenders, 129
 with private equity, 128
 processes, 225
 Dun & Bradstreet (D&B), 166, 171
 D-U-N-S Number, 166–167
 Duties. See Segregation of duties
 Dynamics monitoring, 205
 Dynamics of results, 205

E

E&O insurance. See Errors and omissions insurance
 Earnings, 334
 Earnings before income taxes, depreciation, and amortization (EBITDA), 85, 217
 Earnings per share (EPS), 97
 eBay, 307, 316
 EBITDA. See Earnings before income taxes, depreciation, and amortization
 e-checks, 178
 Economic entity, 232
 EDGAR. See Electronic Data-Gathering, Analysis, and Retrieval system
 EFTPS. See Electronic Federal Tax Payment System
 EIN. See Employer's Identification Number
 Eisenberg, Jesse, 112
 Electronic Data-Gathering, Analysis, and Retrieval system (EDGAR), 132
 Electronic Federal Tax Payment System (EFTPS), 311
 Electronic processing, 179
 E-mail communication, 19, 67
 Employee handbook, 37, 40
 Employee policies, 37–39
 Employee retention, 340–341
 benefits, 340
 moral incentives, 341
 working environment, 341
 Employees' subdirectories, usage of, 50
 Employer's Identification Number (EIN), 164–166
 Employment laws, in foreign countries, 313

- Employment practices insurance, 269
 - Enterprise resource planning (ERP)
 - system vs. special-purpose applications, 187
 - EOLIS, 164
 - EPISTEL (ecological, political, informational, social, technological, economic, and legal), 290
 - EPS. See Earnings per share
 - Equity, 242
 - Equity investments, 96–101
 - founders' investments and company's own capital, 100–101
 - private equity, 98–100
 - angel investments and venture capital, 98–99
 - and mature businesses, 99–100
 - public equity, 97–98
 - ERP solutions, 180, 192
 - ERP system. See Enterprise resource planning system
 - Errors and omissions (E&O)
 - insurance, 267
 - Euler Hermes, 164
 - Europe, Director in, 11
 - Excel, 195–201
 - bubble chart, 199
 - calculable spreadsheet, 196
 - conditional formatting capabilities, 199
 - database and analytical functionality, 196–198
 - integration and beyond, 200–201
 - latest versions, 196
 - visualization tools, 199–200
 - Excise tax, 281
 - Executive reporting, 203–206
 - Exit strategies, 315–322
 - business for sale, 316–318
 - facing reality, 321–322
 - family business, 318–319
 - winding up, 319–321
 - Expenditures, 57–58
 - Expert, definition of, 7
 - Expert perception, 301
 - Exports, 108, 313
 - Express Xcelerator, 200
 - External data, 204
 - External risks, 271
- ## F
- Factoring, 110–111
 - Family business, 318–319
 - Fandango, 120
 - FAS 95, 245
 - FASB. See Financial Accounting Standards Board
 - Fast and painless audits, 257–262
 - audit's timing, 257
 - field examination, 261–262
 - instructions, 260–261
 - preparation, 258–260
 - welcoming auditors, 261–262
 - FCOJ. See Frozen concentrated orange juice
 - Federal Insurance Contribution Act (FICA), 280
 - Federal Reserve Wire Network (Fedwire), 175
 - Federal Unemployment Tax Act (FUTA), 280
 - Fedwire. See Federal Reserve Wire Network
 - FICA. See Federal Insurance Contribution Act
 - Filing Information Returns
 - Electronically (FIRE) system, 283
 - Finance, 59–60
 - and administration, 40–41
 - operational policies, 40
 - VP of, 12

- Finance manager, 10-11
- Financial Accounting Standards Board (FASB), 232, 236, 245
- Financial conglomerates, 124
- Financial cost, 110
- Financial covenants, 136
- Financial director's position, 11
- Financial functions structure
 - for midsize company, 5
 - for small company, 4
 - for small-to-midsize company, 5
- Financial interests, sales of, 110-111
 - factoring, 110-111
 - forfeiting, 111
- Financial leader, key attributes, 224
- Financial professionals, in small companies, 9
- Financial relationship(s), 131-138
 - bankers, 137-138
 - credit line renewal, 138
 - investor relations, 132-133
 - lenders comfortability, 133-137
 - covenants and utilization compliance, 136-137
 - credit lines with monthly reporting, 133-136
- Financial resources vs. business nature, 113-122
- Financial sponsors. *See* Backers
- Financial statements, 23-24
 - and transactional cycles, 239-244
- Financial statements' users, acceptability to, 254-255
- Financial Stress Class, 166
- Financing
 - in cash flow statement, 246
 - definition of, 113
 - features of, 105
- Financing/investing cycle, 243
- FIRE system. *See* Filing Information Returns Electronically system
- Firewall, necessity of, 50
- First Data Resources, 178
- First Union, 173
- Fiscal policy, 43-52
 - data recovery, 49-51
 - information processing, principles of, 46-49
 - accuracy, 48-49
 - authorization, 47
 - completeness, 47-48
 - IT security, 49-51
 - physical controls, 49
 - Sarbanes-Oxley Act, 51-52
 - segregation of duties, 44-46
- Fixed assets, 60, 241
- Flat organizational structures, 4-5
- Floating-rate loans, 276
- Focus Pictures, 120
- Forecasting
 - methods, 302
 - qualitative, 302
 - quantitative, 302
 - and modeling, 297-305
 - cost/benefit analysis, 299-300
 - sensitivity, emphasis on, 303-305
 - simplified, 301-303
 - revenue and gross margin trends, projections of, 303
- Foreign currency, 274
 - management, 179-180
- Foreign entity concerns, 313-314
- Foreign exchange hedging, 274-276
- Forfeiting, 111
- Fortune 500, 142
- Forward contract, 273, 275, 276
- Founders, of private equity, 98
- Founders' investments and company's own capital, 100-101
 - 482 review, 314
- Fra Luca Bartolomeo de Pacioli, 23

Franklin, Benjamin, 279
 Freescale Semiconductor, 116
 Frozen concentrated orange juice (FCOJ), 273
 Full disclosure, 233
 Full-service investment banks, 124
 Functional distribution, study of, 31
 Functional outsourcing, 327
 Functional sectors, 21–25
 accounting management, 23–24
 administration and HR, 25
 audits, 23–24
 capital resources and banking, 22
 cash management, 22
 control processes, 21–22
 financial statements, 23–24
 information, importance of, 23
 managerial reporting, 23
 market analysis, 23
 policies and procedures, implementation of, 21–22
 risk management and compliance, 24
 strategic planning, 24–25
 Fusion-io, 116
 FUTA. See Federal Unemployment Tax Act
 Futures contracts, 274
 FxPro, 180

G

GAAP. See Generally accepted accounting principles
 Garfield, Andrew, 112
 General liability insurance, 266
 Generally Accepted Accounting Principles (GAAP), 23, 231
 Geographical concentration, 278
Geometria, 23
 Global competition, in manufacturing sector, 118

Global Finance, 175
 Global forfeiting, 111
 Global Mergers and Acquisitions Legal Advisory Rankings report (Bloomberg), 317
 Global Payment, 178
 Going concern, 233
 GoodAccountants.com, 253
 Google AdWords, 329
 Great Plains, 193
 Greenwood, Johnny, 17
 Gross profit, 217
 Groupon, 308
 Growth capital investment, 100

H

Handbooks, 38
 Hands-on management vs. micro management, 7
 Harley-Davidson, business structure of, 40
 Hedging, 272–277
 commodity hedging, 273–274
 foreign exchange hedging, 274–276
 interest rate hedging, 276–277
 Hierarchy of Needs (Maslow), 15
 High-visibility position, 8
 Historical cost, 233
 Huffington Post, 111, 121
 Hulu, 120
 Human resources
 acquisition of, 325–332
 expectations, 331–332
 interviewing process, 330–331
 procurement practices, 326–327
 search process, 328–330
 and administration, 25

- Human resources (*continued*)
 - management of, 325, 333–341
 - development and evaluation, 338–340
 - employee retention, 340–341
 - organization, 334–338
- Humphrey, Albert, 289
- I**
- IBM Cognos, 151
- IFRS. See International Financial Reporting Standards
- Imperfectionists, The*, 345
- Import, 108
- Income statements, 242–244, 246
- Incoterms (International Commercial Terms), 234–235
- Independent investment banks, 124
- Indirect method, of cash flow statement, 247
- Indirect tax, 281
- Inflows, 150–151
- Information, importance of, 23
- Information processing, principles of, 46–49
 - accuracy, 48–49
 - authorization, 47
 - completeness, 47–48
- Information technology decisions, 185–194
 - final considerations, 194
 - software, weighing pros and cons, 186–192
 - accounting modules, quality of, 188
 - ERP vs. special-purpose applications, 187
 - online accessibility, 191
 - price, 191
 - reporting capability, 188–190
 - vendor selection, 191–192
 - software packages, 192–194
 - large enterprise solutions, 192
 - Microsoft Dynamics solutions, 193
 - QuickBooks Pro, 193–194
- Initial public offering (IPO), 97
- Inland marine insurance, 267
- Insurable risks, 265–270
 - business insurance products, 265
 - classification, 265
 - insurance, types of, 266, 269
 - malpractice insurance, 266
 - multiline insurance policies, 269
 - umbrella policies, 270
- Insurance. See Specific insurance
- Interest rate cap, 276
- Interest rate collar, 277
- Interest rate floor derivative, 277
- Interest rate hedging, 276–277
- Interest rate swap, 276
- Internal control, 35–41, 65
 - business policies
 - finance and administration, 40–41
 - operations, 39–40
 - components, 36
 - employee policies, 37–39
 - meaning of, 35
 - monitoring, 66
 - policies, 36
- Internal Revenue Code, 314
- Internal risks, 271–272
- International Accounting Standards Board, 236
- International currency trade, 274
- International Financial Reporting Standards (IFRS), 23, 236
- International transfer prices, 314
- Internet, 174
 - visibility, 6

Interviewing process, 330–331
 emailing, 330
 personal interview, 330–331
 phone interview, 330
 second interview, 331
 testing, 331

Inventory and cost of goods sold, 59

Investing activities, in cash flow statement, 246

Investment, 59–60

Investment bankers, 124–125

Investor relations (IR), 132–133

Investors, 123

IPO. See Initial public offering

IR. See Investor relations

IT security, and data recovery, 49–51

iVillage, 120

J

JIT. See Just-in-time inventory policy

Jo-Ann Stores, 119

Job descriptions vs. titles, 9–13

Jordan Company, 117

JPMorgan Chase, 104

Just-in-time (JIT) inventory policy, 40

K

Key performance indicators (KPIs), 75, 206–208

King's Speech, The, 318

Knight, Phil, 326

Knowledge prerequisites, 27–32
 corporate structure, 28–29
 existing policies and procedures, 32
 functional distribution, 31
 operational flow, 30
 organizational chart, 31
 value chain, 30

KPIs. See Key performance indicators

L

Labor, 325

Labor laws, in small business, 39

Labor-reduction convenience, 179

Labor resources, importing of, 326

Large companies, controllers in, 11

Large enterprises , 192
 vs. small enterprises, 6

LBO. See Leveraged buyout

LCs. See Letters of credit

Legal rules, violations of, 24

LegalZoom, 310

Lenders, 117, 128–130
 comfortability, 133–137
 covenants and utilization
 compliance, 136–137
 credit lines with monthly
 reporting, 133–136

Lending, 102

Leonard Green and Partners, 119

Leroy, Jean-Baptiste, 279

Letters of credit (LCs), 41, 107, 110

Leveraged buyout (LBO), 100

Leverage ratio, 129

Liabilities, 241–242

Liaison, appointing, 261

LIBOR. See London Interbank Offered Rate

Licensing, 282

LinkedIn, 116, 124, 322, 328

Lists, for small and midsize companies, 63

Lockbox, 176

Lock-up agreements, 316

Login passwords, treatment of, 51

Logistics company, 119–120

London Forfaiting Company, 111

London Interbank Offered Rate (LIBOR), 104

Lone Pine Resources, 116

Long-term liabilities, 242

M

Macromanagement, of treasury, 141

Malpractice insurance, 266

Managerial reporting, 23

M&A. See Merger and acquisition transactions

Manufacturing/trading companies
aggregate annual budget for, 81

Marine insurance, 267

Market analysis, 23

Marketing, 6

Maslow's Hierarchy of Needs, 15

Materiality, 233

Mature businesses, and private equity funds, 99–100

Mature industries, small businesses in, 298

Media company, 120

Medici, Giovanni, 102

Medici Bank, 102

Merchant services, 177–178

Merger and acquisition (M&A) transactions, 308, 317, 319

MetLife, 272

Micro-management
vs. hands-on management, 7
of treasury, 141, 143

Microsoft Dynamics AX, 193

Microsoft Dynamics GP, 193

Microsoft Dynamics NAV, 193

Microsoft Dynamics SL, 188, 193

Microsoft FRx report designer, 193

Microsoft SQL Analysis, 193

Midsize company
financial functions structure for, 5
lists for, 62
schedules for, 63

Midway Games, 106

Minimum net worth, 136

Mission, of CFO, 16

Mobile banking, 174

Modeling and forecasting, 297–305
cost/benefit analysis, 299–300
sensitivity, emphasis on, 303–305
simplified, 301–303

Monetary unit, 232

Moneylending, 102

Monster, 328

Multiline insurance policies, 269

N

NAICS. See North American Industry Classification System

Napster, 121

National City, 111

National Venture Capital Association, 127

Navision Financials, 193

NBC Entertainment, 120

NBC News, 120

NBCUniversal, 120

NDA. See Nondisclosure agreement

.NET Framework, 48

Net operating income, 280

Net present value (NPV), 300

Net profit, increase of, 298

Netscape, 121

Net worth, 129

NewBay, 317

- New domestic entity setup, checklist for, 309–312
 - New Mountain Capital, 116
 - New ventures, 307–314
 - entity, creation of, 308
 - foreign entity concerns, 313–314
 - New Domestic Entity Setup, checklist for, 309–312
 - New York Mercantile Exchange (NYMEX), 273
 - New York Times*, 121
 - Nexia International, 254
 - Nike, 326
 - Non-cash items, in cash flow statement, 250
 - Nondisclosure agreement (NDA), 168
 - Nonrecourse transaction, 111
 - North American Industry Classification System (NAICS), 113
 - Notable procedures, 56–61
 - accounts payable, 57–58
 - banking, 59–60
 - expenditures, 57–58
 - financing, 59–60
 - fixed assets, 60
 - inventory and cost of goods sold, 59
 - investing, 59–60
 - month-end procedures, 60–61
 - payroll, 57–58
 - revenues and accounts receivable, 56–57
 - year-end actions, 61
 - NPV. *See* Net present value
 - Numeration formulas, 196
 - Nursing professionals, deficit of, 326
 - NYMEX. *See* New York Mercantile Exchange
- O**
- Official documents, 109
 - Online accessibility, 191
 - Online banking, 174
 - Online credit card payments, 178
 - Operating activities, in cash flow statement, 246
 - Operational flow and value chain, study of, 30
 - Operational policies, 40
 - Oracle, 192
 - Orient, 326
 - Outflows, 150–151
 - Outsourcing, in manufacturing sector, 118
 - Owner's proximity, 8
- P**
- Paid-time-off (PTO) concept, 341
 - Palo Alto Software, 126
 - Patriarch Partners, 100
 - Payables. *See* Credit payables
 - Payables solutions, 178–179
 - Paychex, 180, 311
 - Payment gateway, 178
 - Payment reputation, 178
 - Payroll, 57–58
 - management, 180–181
 - tax, 280
 - P/E. *See* Price-earnings
 - Performance analytics, 203
 - Performance reporting, 204
 - Permanent vs. temporary employment, 327
 - PEST (political, economic, social, and technological), 290
 - Physical controls, in fiscal policy, 49
 - Physical observation, in formal auditing, 67–68
 - PIPE. *See* Private investment into public equity

Pivot table, 197, 198

Plum Card, 179

PNC Bank, 111

Policies
 meaning of, 36
 operational, 40
 and procedures, implementation
 of, 21–22

Political risk insurance, 268

Politics, in companies, 8

Power Resume Search
 (Monster), 329

Price, 255

Price/cost of system, 191

Price-earnings (P/E), 97

Principle of conservatism, 150–151

Prioritization rules, 19

Private equity, 98–100
 angel investments and venture
 capital, 98–99
 backers, 98
 due diligence with, 128
 firms, 127–128
 founders, 98
 funds, 99–100

Private investment into public equity
 (PIPE), 100

Procedure(s)
 designing, 54
 documenting, 61–62
 implementation of, 21–22
 layouts, 54–55
 meaning of, 36
 notable procedures, 56–61

Product concentration, 278

Production, 6

Product liability insurance, 267

Professional growth, 18

Professional liabilities insurance. See
 Malpractice insurance

Profitability, 85
 calculation, 89–90
 control point, 88

Profit criteria, establishment of, 90

Project profitability assessment step, 88

Property insurance, 266

Property tax, 281

Proportioni et proportionalita, 23

PTO. See Paid-time-off concept

Public equity, 96–98

Public stocks, 315

Q

Quality control, 255

QuickBooks, 180

QuickBooks Pro, 193–194

Quintessential tasks, 53–63
 documenting procedures, 61–62
 key elements, 53–54
 notable procedures, 56–61
 accounts payable, 57–58
 banking, 59–60
 expenditures, 57–58
 financing, 59–60
 fixed assets, 60
 inventory and cost of goods
 sold, 59
 investing, 59–60
 month-end, 60–61
 payroll, 57–58
 revenues and accounts
 receivable, 56–57
 year-end actions, 61
 procedure layouts, 54–55
 scheduling, importance of, 62–63

R

Rachman, Tom, 345

RDC. See Remote deposit capturing

RDSs. See Remote deposit services

Real estate and rentals, 122

- Real-time liquidity management, 174
- Receivables solutions, 176–177, *see also* Credit receivables
- Recourse transaction, 111
- Remote deposit capturing (RDC), 177
- Remote deposit services (RDSs), 177
- Reporting capability, of software, 188–190
 - data exportability, 189–190
 - data warehousing, 190
 - drill-down features, 189
 - ease of data querying*, 189
 - predefined system-generated reports, 188
 - report writers, integration with, 190
- Report writers, integration with, 190
- Research in Motion (RIM), 317
- Resume database access (CareerBuilder), 329
- Return on equity (ROE), 97
- Return on investment (ROI), 96
- Revenue(s)
 - and accounts receivable, 56–57
 - creation, 85
 - volume, 219
- Revocable LC, 109
- RIM. *See* Research in Motion
- Risk management and compliance, 24
- ROE. *See* Return on equity
- ROI. *See* Return on investment
- Rosenthal & Rosenthal, 111

- S**
- SaaS. *See* Software as a Service
- Sales, 6
 - vs. borrowing*, 110–111
 - and use tax, 281
- SAP, 192
- SAP Business One, 192
- Sarbanes-Oxley (SOX) Act, 51–52, 97, 125
- Schedules
 - importance of, 62–63
 - for small and midsize companies, 63
- Schneiderman, Art, 290
- Search engine optimization (SEO), 329
- SEC. *See* Securities and Exchange Commission
- Securities and Exchange Commission (SEC), 97, 132
- Segmental analysis, 215–222
 - allocation hurdles, 218–219
 - by location for service company, 220
 - principles of, 216–217
 - profitability analysis, 216–217
 - organizational structure, 216
 - profitability stimulants, 217
 - revenue generation composition, 216
 - purpose of, 215
 - scenario, 219
 - segmental chart of accounts, 217–218
- Segmental chart of accounts, 217–218
- Segmentation exercise, 216
- Segregation of duties, 44–46
 - for wire transfers and check payments, 45
- Self-actualization, 16
- Self-tracking mechanisms, 87
- Sensitivity
 - analysis, 303, 304
 - emphasis on, 303–305
- SEO. *See* Search engine optimization
- Server/client architecture, 192
- Service sector, 122
- SFAS. *See* Statements of financial accounting standards

- Shipping documents, 109
 - Sight LCs, 109
 - Signature loans, 105
 - Six-disks-a-week backup policy, 50
 - Small business, 3–8
 - flat organizational structures, 4-5
 - hands-on-management, 7
 - high concentration of duties, 6
 - labor laws in, 39
 - owner's proximity, 8
 - Small-business accounting systems, 151
 - Small companies
 - financial functions structure for, 4, 5
 - financial professionals in, 9
 - vs. large enterprises, 6
 - and midsize companies
 - lists for, 62
 - schedules for, 63
 - Social Network, The (2010), 112
 - Social networking, 328
 - Software, weighing pros and cons, 186–192
 - accounting modules, quality of, 188
 - ERP vs. special-purpose applications, 187
 - online accessibility, 191
 - price, 191
 - reporting capability, 188–190
 - vendor selection, 191–192
 - Software as a Service (SaaS), 192
 - Software packages, 192–194
 - large enterprise solutions, 192
 - Microsoft Dynamics solutions, 193
 - QuickBooks Pro, 193–194
 - Solazyme, 116
 - Solomon, 193
 - SOPs. See Statements of positions
 - Sourcing concentration, 277
 - SOX. See Sarbanes-Oxley Act
 - Special permits, 282
 - Spirit Airlines, 116
 - Spot contract, 275
 - Spreadsheets. See Excel
 - Staffing, 329
 - Start-up company, controller in, 11-12
 - State payroll tax services Harrison, PA, 253
 - Statements of financial accounting standards (SFAS), 236
 - Statements of positions (SOPs), 236
 - STEER (sociocultural, technological, economic, ecological, and regulatory), 290
 - Stock trading, 97
 - Strategic planning, 24–25, 287–295
 - CFO's role, 293–294
 - example, 295
 - future-planning methods, 291–293
 - theory of, 289–291
 - Strategy, definition of, 287
 - Summa de arithmetica* (1494), 23
 - Super Bowl XLV, 121
 - Sweep account, 144
 - SWOT (strengths, weaknesses, opportunities, and threats) analysis, 289, 292
- ## T
- T-accounts, 69–71
 - Talent search, 328
 - Taomee Holdings, 116
 - Tax and regulations compliance, 279–284
 - Taxation, 24
 - Tax evasion, 282
 - Tax offenses, 282–283
 - TEC Group, 163, 170
 - Technology/service companies, detailed monthly budget for, 83

Telemundo, 120
Temporary vs. permanent employment, 327
Term LC payments, 109
Term sheet, components, 130
Terrorism, in United States, 268
Terrorism Risk Insurance Act (TRIA), 268
TheLadders, 328
Tilton, Lynn, 100
Time organization, 19
Titles vs. job descriptions, 9-13, 15, 21, 27, 35
 accounting/finance manager, 10-11
 Chief Financial Officer, 12-13
 controller, 11-12
 Director of accounting/finance, 11
 VP of finance, 12
Trade finance, 107-110
Trade Finance group, 158
Trade references, 167
Trading company, 119
Trading credit risk, 272
Trading Places, 273-274
TradingPoint, 180
Transactional cycles, 56, 239, 240, 241
 and financial statements, 239-244
Transactional profitability control, 88-90
 best point of control, determination of, 88-89
 control procedure, 90
 profitability calculation, 89-90
 profit criteria, establishment of, 90
Transactional totals vs. control accounts, 71-72
Transparency, 97
Transposing digits, mathematical effect of, 69

Treasury function, 141-144
Treasury management services, 173-181
 demand deposit account services, 174-176
 foreign currency management, 179-180
 merchant services, 177-178
 payables solutions, 178-179
 payroll management, 180-181
 receivables solutions, 176-177
TRIA. See Terrorism Risk Insurance Act
Trial balance, 259
Triton LLC, 180
12-Month D&B PAYDEX, 166

U

UCC. See Unified Commercial Code
Umbrella policies, 270
Unified Commercial Code (UCC), 105
Unilateral foreign currency transaction, 158
United States, Director in, 11
Universal Pictures, 120
Unlimited recruitment search (LinkedIn), 329
USA Networks, 120
US business taxes, 280
US Small Business Administration site, 284

V

Value-added taxation (VAT), 313
Value chain, study of, 30
VAT. See Value-added taxation
Vendor selection, 191-192
 cloud technology and SaaS, 192
Venetian method of bookkeeping, 23

Venture capital firms, 118
Venture capitalists, 126
Venture capital vs. angel investment,
98–99
Vice President (VP), of finance, 12
Vistage, 163
Voluntary SOX compliance, 52

W, X

Wachovia, 173
Wachovia Bank Conference, 18
Warner Brothers, 106
Weakest link, 65–75
 common-sense tests, 68–71
 company performance reviews, 75
 completeness, 72–73
 control accounts vs. transactional
 totals, 71–72
 cutoff tests, 73–74

 human error, 66
 physical observation, 67–68
Weighted average cost of capital, 300
Wells Fargo, 111, 176
Wire transfers, 176
 and check payments, 45
Workers' compensation
 insurance, 266
Working capital, 141
WorldCom, 121

Y

Yandex N.V., 116
Yellow pad, 301
Yorke, Thom, 17

Z

Zuckerberg, Mark, 12, 112, 321

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A Hands-On Guide to
Keeping Your Business Solvent and Successful

Marina Guzik

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CFO Techniques: A Hands-On Guide to Keeping Your Business Solvent and Successful

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*To Yana,
the only person I ever wanted to impress.*

About the Author

Marina Guzik's career in finance and accounting spans 24 years, with the last 17 years in chief financial officer and controller positions in small and midsize companies. She has worked in both the public and private sectors, including manufacturing, global supply chain, e-commerce, professional services, asset management, and consulting. Marina's functional expertise spans a broad range of tasks and duties, from international treasury to mergers and acquisitions, and everything in between. She holds several academic degrees, including a master's in business administration in accounting. She believes in the strength of fundamental knowledge and commercial acumen, which can be intelligently applied to any particular business model.

About the Technical Reviewer

Randy Krug is a CFO with over 25 years of finance and accounting experience in a diverse field of industries, including public accounting. His career features a 15-year stint with the world's largest brewer, and he has actively engaged national board participation in technology and e-commerce strategy planning with all of America's best-known brands. Randy enjoys peer networking as evidenced by over two decades of participation in a local financial executive network for continuing education, and he founded the national Anheuser-Busch Controller's Roundtable for the purpose of best-practice professional development. A product of Iowa's agricultural heritage, he and his wife Sheila live near Cedar Rapids and are the proud parents of two adult sons.

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