PART ONE

Reports and Filings

CHAPTER ONE

Chief Financial Officer's Role and Reports

ROLE OF THE CHIEF FINANCIAL OFFICER

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

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

The CFO affects stockholder wealth maximization by influencing:

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

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

Exhibit 1.1 presents the functions of the CFO.

EXHIBIT 1.1 Functions of the CFO

A. Accounting and Control
Establishment of accounting policies and internal control
Development and reporting of accounting data
Cost accounting
Internal auditing
System and procedures
Government reporting and filings
Report and interpretation of results of operations to management
Comparison of performance with operating plans and standards
B. Planning
Long- and short-range financial and corporate planning
Budgeting for operations and capital expenditures
Evaluating performance
Pricing policies and sales forecasting
Analyzing economic factors
Appraising acquisitions and divestment
C. Provision of capital
Short-term sources; cost and arrangements
Long-term sources; cost and arrangements
Internal generation
D. Administration of Funds
Cash management
Banking arrangements
Receipt, custody, and disbursement of company's securities and moneys
Credit and collection management
Pension money management
Investment portfolio management
E. Protection of Assets
Provision for insurance
Establishment of sound internal controls
F. Tax Administration
Establishment of tax policies
Preparation of tax reports
Tax planning

(continued)

EXHIBIT 1.1 *(continued)*
G. Investor Relations
Maintaining liaison with the investment community
Counseling with analyst regarding public financial information
H. Evaluation and Consulting
Consultation with and advice to other corporate executives on company policies, operations, objectives, and their degree of effectiveness
I. Information Technology and Management Information Systems
Development and use of information technology (IT) facilities
Development and use of management information systems
Development and use of IT systems and procedures

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

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

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

Many controllers are involved with management information and IT systems, and review previous, current, and emerging IT patterns. They report their analysis of the financial implications of decisions to top management. Controllers are called on to establish, monitor, and analyze the internal control structure of the company to the extent that those controls impact the company's financial statements. At times, controllers may be called on to consider operational controls broader in scope. In particular, for SEC registrants that fall under Sarbanes-Oxley 404 requirements, controllers are required to obtain an independent auditor's opinion as to whether the control design and operating effectiveness are able to prevent a material misstatement in the financial statements. For entities that are not SEC registrants, much of the Sarbanes-Oxley 404 requirement could be considered best practice. In this regard, a risk-based control self-assessment program is a useful starting point. Tools such as internal control questionnaires or process maps may be useful. It is important to keep in mind that every company is different, and, therefore, the internal control self-assessment process should be tailored to the particular needs and peculiarities of each company. When designing a control self-assessment process or modifying controls, it would be prudent to obtain the external auditor's view at the onset to facilitate that auditor's function and lessen audit costs.

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

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

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

EXHIBIT 1.2 Functions of Controller and Treasurer

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

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

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

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

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

What are prospective financial statements?

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

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

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

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

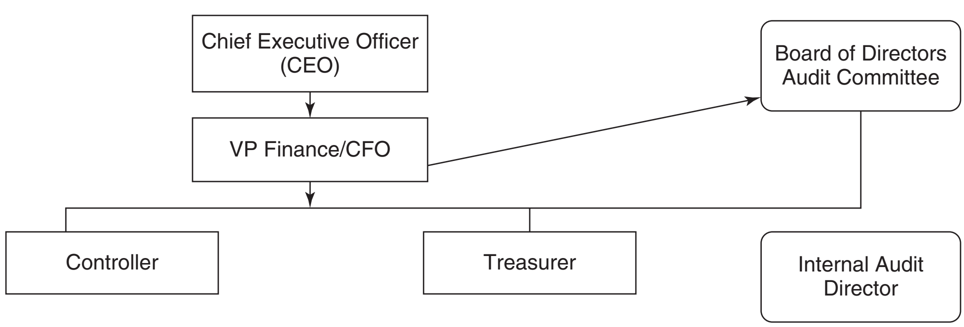

EXHIBIT 1.3 A Typical Financial Structure

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

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

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

What should be contained in financial forecasts and financial projections?

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

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

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

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

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

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

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

Why are information reports useful?

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

How can reports be used to analyze and control operations?

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

Why are exceptions to the norm significant to note?

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

What should the board of directors know?

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

What special occurrences should be reported?

Special situations and circumstances may occur that require separate evaluation and study. For example, it may be necessary to identify the cause for a repeated decline in profitability of a given product, service, or territory. There may be a need for a feasibility analysis of whether to open a new store location or plant. Other reports may be in connection with union negotiations, commercial contract reviews, pension plan administration, bonus plans, and product warranty issues. It is essential that the reports contain narrative and statistical analyses of the decision with graphic presentations as needed.

What reports may segment managers find useful in decision making?

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

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

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

How can reports be directed to improving quality?

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

EXHIBIT 1.4 ABC Company Statement of Revenue and Expense for Employees for the Year Ended December 31, 2X12

	Total Amount	Amount per Employee	Costs per Dollar of Receipts
Business Received			
From customers for merchandise or services performed			
Interest			
Dividends			
Total amount received			
Business Expenses Incurred			
For raw materials, supplies, and other expenses			
Depreciation			
Taxes			
Total expenses			
Residual for salaries, dividends, and reinvestment in the company			
This was divided as follows:			
Paid to employees (excluding officers' salaries)			
Paid for employee fringe benefits			
Total			
Executive salaries			
Executive fringe benefits			
Dividends to stockholders			
Reinvested in the company for expansion			
Total division			

What types of information might interest employees?

Reports (see Exhibit 1.4) can be directed toward the interests and concerns of employees and contain this information:

- Revenue and/or profitability per employee
- Revenue relative to employee salaries
- Assets per employee
- Profit margin
- Sales volume or service hours
- Investments made to directly or indirectly benefit employees
- Explanation of changes in benefit programs (e.g., health insurance, pension plan)

- Percentage increase in salaries, fringe benefits, and overtime
- Dividends relative to wages and number of employees
- Corporate annual growth rate; comparison of employee salaries to that of competing companies and industry averages
- Real earnings after adjusting for inflation
- Analytical profit and cost information by responsibility center
- Assets by business segment
- Future prospects and problems in the company, industry, and economy
- Break-even point
- Actual and expected production
- Employee safety
- Compliance with federal, state, and local laws pertaining to employee working conditions
- Sources of financing
- Nature and type of assets held
- Overall financial health of the company

GOVERNMENTAL REPORTING

The CFO may have to prepare reports to federal, state, and city governmental agencies. Antitrust laws, environmental protection laws, pension laws, product liability laws, pollution laws, laws governing international trade and commerce, and tax laws are but a few of the myriad reports with which the company must contend. Penalties may be assessed for failing to file reports on time.

What does the New York Stock Exchange want to know?

The listing application to the New York Stock Exchange (NYSE) contains an agreement to provide annual and interim reports including financial statements and disclosures. The reports must be filed on a timely basis because the information they contain may have a material influence on the market price of stock, bond ratings, and cost of financing.

REPORTING UNDER THE SARBANES-OXLEY ACT

SOX has had a significant impact on CFOs and their reporting responsibilities. It has changed how public companies are audited and has made adjustments to the financial reporting system. The Act has also created the PCAOB to enforce professional standards. In addition, it has increased corporate responsibility and the usefulness of corporate financial disclosures. CFOs must personally attest to the truth and fairness of their company's disclosures. The next provisions and requirements are promulgated under the Act as it applies to CFOs:

- CFOs cannot engage in any action to fraudulently influence, coerce, manipulate, or mislead the independent auditor.
- CFOs must certify in the annual report that they have reviewed the report and that it does not include untrue statements or omissions of material information.
- CFOs must establish and maintain internal controls to ensure proper reporting.
- CFOs are prohibited from falsifying records.
- Pro forma financial data in any report filed with the SEC or in any public release cannot include false or misleading statements or omit significant information needed to preserve the integrity of the financial data.
- The company's audit committee is responsible for the selection and oversight of the auditing CPA firm.
- An independent audit committee is required.
- No insider trading is allowed during pension fund blackout periods.
- Significant off-balance sheet transactions, arrangements, obligations, and other relationships must be disclosed. Disclosure must be made on material aspects related to financial condition, liquidity, resources, capital expenditures, and components of revenue and expense.

XBRL REPORTING

Extensible Business Reporting Language (XBRL) is an *intelligent* Internet language that can be used in business by preparers and users of financial statements including corporate accountants, CPAs, financial analysts, business managers (in reviewing reports), loan officers at banks, investors, suppliers, securities exchanges (e.g., NYSE), over-the-counter market members of Nasdaq, and federal and local governmental agencies (e.g., the SEC and Internal Revenue Service). By comparison, the Hypertext Markup Language (HTML) format is not intelligent enough as a language to understand and reveal relationships in accounting and financial data. HTML is not designed to be aware of the information it presents. XBRL closes the "communication gap" between the preparers and users of financial data on the Internet.

XBRL represents a major step forward in the preparation, publication, exchange, and analysis of financial data. It results in a simpler process for issuing financial reports and making investment and credit decisions. XBRL standardizes financial reports by clearly specifying and defining each item of data, using clearly defined tags. This allows XBRL-enabled software to accurately read and understand the figures, store them, and compare them.

The precise definitions, or tags, are necessary because terms such as "revenue," "income," "fees," "stock," and "inventory" can have a variety of meanings, depending on the organization. Humans use judgment to interpret financial data, but for computers to make sense of it, they need precise definitions. The SEC requires public companies to prepare interactive financial statement data in XBRL format by 2013. For more on XBRL, see Chapter 19.

OTHER REPORTING

Many groups, such as trade associations, state commerce departments, federal bureaus and agencies, and credit agencies, compile statistics on business performance. These groups receive and complete questionnaires and reports on a wide range of topics.

The CFO's role in reporting information cannot be understated. Besides being able to formulate relevant financial and nonfinancial data, the CFO must be able to effectively and efficiently communicate that information to management, employees, government, investors, creditors, and other interested parties. The CFO should submit these reports in a timely way so that up-to-date information is available for decision-making purposes.