

Early warning signs and implications for CEO's and CFO's

(Part 1)

Introduction

CEO's and CFO's need to have a long hard think about their personal liability position. Good management practices will reduce their legal exposure.

In a well-managed company, CEO's and CFO's have their job descriptions. They manage the company's dealings within the risk strategy adopted by the board of directors.

When a company is poorly managed and begins to face financial difficulties, the role of the CEO and CFO changes significantly. The CEO and CFO becomes a problem solver under immense pressure, perhaps on a daily basis, to find funds to cover the company's immediate short-term cash flow needs. In these situations, the company often has an inadequate financial reporting system. The daily focus is on cash flow at the expense of other issues.

Long before it gets to this hand-to-mouth situation, CEO's and CFO's are in a very good position to realise that the way their company is operating is unsatisfactory and is likely to lead to problems.

In this paper, we cover typical early warning signs of management problems; the basic elements of good management; and some comments on the position of a CEO and CFO, both from the point of view of assisting their company, and from the point of view of potential personal liability.

Causes of collapses

Commentators, partly depending on their allegiances, place different weightings on the various factors which appear to cause collapse. Factors blamed include the bias towards high gearing ratios; speculation in the capital value of assets; bank lending practices; poor management by borrowers; inadequate corporate regulation and poor corporate morality; and government management of macro-economic policy.

Bad management has been the most significant cause of corporate failure.

The inability of a company to withstand major setbacks without becoming insolvent usually stems back to bad management; either in the sense of a totally flawed business strategy, or simply through inappropriate speculation with borrowed funds.

Most matters we see involve a high profile domineering individual as their Chief Executive, which is itself a warning sign of potential management problems. Some of the corporate failures have had within their structure some very successful and well-managed businesses.

Corporations often fail, not through losses suffered in their core trading businesses, but through their inability to meet debt-servicing costs on borrowed funds utilised on projects which could not meet their own short term cash requirements from income. If management and lenders had placed greater emphasis on good cash flow planning, problems could be identified earlier.

Can company failure be predicted?

The fact is that businesses fail in both good and bad times, and that a significant proportion of businesses fail within several years of their formation. Business failure can often be predicted, because most business failures give ample warning of impending financial collapse. Management, shareholders and creditors who recognise the early warning signs are in a position to act before serious damage is done.

Early warning signs

Typical early warning signs of management problems and, hence, potential failure are:

- a domineering executive
- uninvolved board of directors
- lack of cash flow forecasting
- lack of budgeting generally
- lack of financial information
- delays in presentation of information
- failure to compare actual results with budgets and take action on a timely basis
- undercapitalisation for the activities attempted
- speculation in asset values rather than concentration on core production activities
- gross profit or net profit margin erosion
- concentration on one big project at the expense of the existing business
- problem borrowing
- declining service standards

Many businesses have, of course, managed to survive while displaying some of these warning signs. They are not inflexible rules. They are simply a warning that good management practices are not in place.

Lessons for management

In a well managed company, we would expect to find the converse of these early warning signs. We would expect to find an involved board of directors who:

- places a high priority on planning and business risk assessment;
- ensures that their company has a strong financial function;
- is capable of recognising problems and taking action early; and
- takes their statutory responsibilities as company directors very seriously.

These elements of good management are often missing in corporate collapses, and they are also missing in a very high percentage of the small business failures which make up the bulk of our business.

The importance of planning – the first lesson

From an individual company's point of view, the first basic lesson is the importance of planning. Success sometimes occurs in spite of lack of planning, but normally in any commercial enterprise the only way to ensure success is to draw up plans based on achievable assumptions and to work those plans through to make sure that if everything goes according to plan, the results will be satisfactory. We do not mean that every business strategy should be profitable in the short term. It may be that a discounting period is a justified management decision, but before making the decision, management should be aware of the expected impact on cash flow and profit. Management can only be sure of this by using financial budgeting. Plans or budgets should be produced by management (or consultants if necessary) and then ratified by the board as being budgets which, if they were achieved, the board (and, presumably, the shareholders) would be pleased with.

The planning process also involves business risk assessment. All businesses are subject to risks due to variables beyond their control, but many of those risks can actually be identified. For example, speculators in the property industry are subject to the risk that asset prices will level off or actually decline. It is up to the speculator to decide whether to accept that risk in view of their assessment of the potential for gain.

In a company's case, the planning adopted by a board of directors should not expose the company to failure merely because an identifiable risk moves against the company. Directors need to ask themselves "What if" questions relevant to their particular business. Examples are:

- "What if interest rates remain high?"
- "What if exchange rates move against us?"
- "What if budgeted turnover is not achieved?"
- "What if property prices fall?"

If the answers are that the business would not survive, the business plans need to be adjusted to reduce the company's exposure to the particular risk involved.

The need for a strong financial function – the second lesson

There is a need for good financial reporting systems. There is a tendency for those of us trained in financial management to assume that business managers have some basic understanding of finance and accounting skills. We are wrong to make that assumption. There are a variety of other skills involved in running a business successfully, including:

- selling skills;
- marketing skills;
- administrative ability; and
- personnel management.

Some successful business people are able to combine all of the necessary skills and run their business personally. However, a more common occurrence is that successful business people do not hold all the necessary skills personally, but instead make use of their own skills and the skills of others as the need arises.

The lack of finance and accounting skills is obvious in many corporate failures. Some directors believe it is possible to run a business with scant regard to conventional financial practice. Typical examples are the total inability to distinguish between cash and profit, failure to use budgeting as a planning tool, and failure to use regular reporting of actual results to adjust business' strategies. Surprisingly common is the failure to keep proper books and records. How can directors expect to make good planning decisions if they are unable to determine their company's current position, or the effect that previous decisions have had? The lesson for directors is that they must ensure that their company has a strong financial function, capable of producing up to date financial reports and forward budgets on a timely basis, and the directors must make use of an analysis of those reports to enable them to monitor and assess the success of the company's various activities.

Monthly reporting is almost universally accepted as good business practice, and many larger businesses in fact now report more frequently. Monthly reports allow management to assess how their plans and budgets are in fact working out, and to take whatever remedial action appears to be necessary before problems become critical. In order for the monthly reports to be useful, they of course must be analysed and compared with the expected results. Financial trends need to be explained, particularly if they are unfavourable. The only reason for taking no action would then be because the unfavourable trend has been explained and accepted as temporary.

We often take charge of companies where company records show no sign of monthly budgeting or cash flow planning, and where financial reports are only available to the board on an annual basis.

(Next Tuesday, Part TWO will conclude this article.)