

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

(Part 2)

The need for early recognition of problems – third lesson

A third lesson is that companies need to use their planning and regular financial reporting process not only to identify any developing problems which need corrective action, but also to identify well in advance those periods in which the company will require additional accommodation from its lenders. Borrowers should not automatically presume lending contracts will be rolled over as they mature. Even those companies which otherwise would not have financial problems are likely to find that as lending contracts mature, they must provide their lenders with more convincing reasons why credit should be extended than has been the case in the past.

Early dialogue is an important part of lender confidence and is very important when financial problems arise. The earlier the dialogue with lenders, the greater the chance a financial problem can be resolved successfully. There is rarely any chance of success if:

- the problems are left until the last minute;
- incomplete financial information is available;
- unrealistic courses of action are proposed; and
- crisis management is obvious.

It is crucial to maintain lender confidence if directors are to persuade the lenders to assist a company out of its problems. Perhaps the best way of increasing the chances of refinancing is for directors to place themselves in the lenders' shoes, and ask themselves what would they want to see in order to justify continuing to extend credit to the company. We suggest the following basic rules are essential for successful negotiations with lenders:

The Borrower

- must ensure early dialogue with lenders;
- must be able to provide up to date financial information, and be able to
- demonstrate the capacity to produce reliable financial information on a regular basis;

- must propose realistic courses of action. They should be supported by forward budgets based on achievable turnover, asset sales, etc; and,
- must be able to demonstrate adherence to promises and budgets presented as negotiations continue.

Entering negotiations without up to date financial information, or without realistic forward planning, is guaranteed to lead to lender frustration and loss of confidence.

Comments on the CEO and CFO position

The CEO and CFO should be aware of the extent to which the Board of the company does give a priority to planning and risk assessment, and does give a priority to a strong financial function. The CEO and CFO is ideally placed to know whether a company displays any of the early warning signs of management problems. The CEO and CFO should be able to determine whether the company appears to be run by a domineering executive, and whether the company places any priority on planning, financial reporting, and comparisons of actual results to budget.

CEOs and CFOs must remain aware of the early warning signs of poor management and to do what they can to boost the planning and reporting process. CEOs should:

- make it known that they are unable to fulfill their role properly unless long term planning is in place
- actively require cash flow budgets to re-enforce the point that CFOs need them and wish to contribute to the analysis of them;
- analyse cash flow budgets produced for their impact and particularly, analyse the underlying assumptions of the budgets to obtain an understanding of their sensitivity to particular events such as proposed asset sales;
- contribute to the comparison of actual results to prior budgets, particularly from the point of view of ensuring that forward cash flow planning is adjusted accordingly; and,
- when the CFO believes the company is consistently cutting it too fine on funding arrangements, contribute feedback by reporting on both the cost effect of regularly meeting routine funding requirements on an emergency basis, the damage being done to credibility, and the need to curtail management's expenditure programs or flamboyant habits.

Potential personal liability

A problem of even more direct concern to CEOs and CFOs, and one which many may have been underestimated in the past, is the potential for personal liability where they have been participating in the management of a failed company.

There are fairly daunting possibilities of recovery of compensation from directors personally for failure to act with reasonable care and diligence, and under Section 556 when directors have allowed the company to incur debts when there are

reasonable grounds to expect the company will not be able to pay all its debts as when they become due. It will be a very brave director who allows a company to continue incurring credit without having a good knowledge of the company's financial position, updated on a regular basis.

Company directors are certainly becoming more aware of their very heavy responsibilities under Sections 180 and 556 of the Companies Act, but probably what is less widely known, is that both Sections can be applied to officers of companies, even though they are not directors e.g. CEOs, CFOs and other employees.

Section 556, after detailing the offence of incurring credit while insolvent, states in part

"any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred is guilty of an offence and the company and that person or, if there are two or more such persons, those persons are jointly and severally liable for the payment of the debt".

The test for determining whether a particular company officer has the potential personal liability under Section 180 or Section 556 is whether they took part in management of the company. There is no doubt that many employees would be regarded as having taken part in the management of their company, and in many instances, they are directly instrumental in the incurring of significant credit. Accordingly, CEOs and CFOs need to take a very active interest in whether their company exhibits the basic elements of good management.

Successful companies will be those companies which place a high priority on planning and business risk assessment, which have a strong financial budgeting and reporting systems, who use their reporting systems for early identification and resolution of problems, and whose officers pay careful attention to their statutory responsibilities.

This is the final part for this topic. If you didn't receive Part 1, you will find it on our website along with this edition - Part 2.