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Extract from: The Financial Analysis and Cashflow Manual

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1-2000

CORPORATE GOVERNANCE AND FINANCIAL ANALYSIS

The relationship between the boards of companies (or other organisations) and the financial performance of these organisations is critical for the success of these enterprises and their management. It is also fundamental for companies to understand how to use financial analysis in relation to their board's needs, in order to govern the business successfully. This use of financial analysis must be seen in the broader context of corporate governance.

Corporate governance has become very high profile over the past few years as corporate collapses have prompted investigation and research into this area. For example, in the UK the Cadbury Report on the Financial Aspects of Corporate Governance was issued in 1993, in France the Vienot Report was issued, in Germany the 1995 OECD Report was issued, and in Hong Kong the stock exchange's 'Guidelines for Directors' report was issued. These reports recommended various procedures that boards could use to improve shareholders' understanding of how the company's finances are controlled. Among the recommendations of the Cadbury Report were the use of independent non-executive directors and the splitting of the chairman and the chief executive roles. The London Stock Exchange is moving to make two of the recommendations of the Cadbury Report — that the auditors certify that the company is a going concern and that the directors certify that their internal controls are adequate — mandatory for listed companies.

In the USA boards have taken a more active role in assessing the financial performance of the companies, which are under the management control of the senior line management; sometimes these boards are removing senior executives based on their financial performance (General Motors, Kodak, American Express and Westinghouse have done this).

One area in which boards are under pressure to perform is that of creating shareholder value as a central business and strategic financial objective. In the USA, where shareholder value concepts have been well accepted, it is well documented that listed companies which have adopted shareholder value as an objective have been successful in terms of their stock market performance. The analysis of these concepts has been carried out by the USA consultancy Stern Stewart, which has shown that companies adopting shareholder value as an objective have raised their share price at three times the rate of the market, with some companies (such as Coca-Cola and Briggs and Stratton) quadrupling their value over five years, and others (such as New Zealand's Fletcher Challenge and Quaker Oats in the USA) doubling their share market value under the shareholder value financial system.

1-2020 **ORGANISATION'S FINANCIAL HEALTH DEPENDENT ON BOARD'S FUNCTIONING**

To understand the interaction between boards and financial analysis you need an appreciation of the board's roles and challenges and the link between the board's roles and the supporting financial analysis. Good corporate governance suggests that organisational financial health depends on having a thoughtful and committed board of directors at the heart of the company, rather than just good managers. The board must strike a balance between internal and external pressures to ensure the company's financial survival. The board must give clear direction and create the appropriate emotional climate, which will set the people in the intended direction and create the desired performance by the organisation. The board must ensure that a sufficient number of people are aligned and committed to a common purpose, with similar values and behaviours, to ensure that their organisations can function effectively, efficiently and in a sufficiently profitable fashion.

Each board member is personally responsible and liable financially for their duties and tasks. Directing is a very intellectual activity and boards should show the way ahead and give leadership. Boards require a range of thinking and analytical skills and a great deal of support from their professional advisers. An example of where proper financial analysis is not used to support strategies is the obsession with organisational rationalisation, which may eventually kill off the organisation. These management fads can be dangerous and require financial and strategic analysis to support the strategies. The directors must put individual strategies into their broader strategic perspective and work out their impact on the financial performance. Management's task is to break down the strategies into operational tasks to form the operational plan of the organisation, and then to implement these tasks.

1-2030 **Directing a serious job**

The board members' task of directing is a serious job and must be tackled with sufficient resources, proper skills and sufficient back-up. Directors must budget time for directing over the year.

The directors provide leadership to ensure that the organisation:

- reaches targets;
- learns to self-manage;
- achieves budgets;
- hits predetermined milestones;
- creates shareholder value.

1-2040 **Managers v. directors**

The distinction between managing and directing is critical to the success of the business. A potential problem for any organisation is that some directors may slip back into their previous managing roles and intervene directly in management, even creating situations that allow them to intervene. The directors should create political, strategic and emotional environments that promote high performance. The board is the centre of the organisation, its business brain, and should monitor the organisation's results, both external and internal.

1-2050 **Four dynamic balances for directors' focus**

The directors should focus on the following four main areas, which should be attended to systematically, with sufficient time and resources dedicated to the board cycle to ensure their completion:

- *organisational effectiveness*: external long-term focus on customers' perception of good value for money;
- *organisational efficiency*: internal short-term focus on cost reduction and efficiency gains;
- *board performance*: external focus on policy formulation relating to the external environment, strategic thinking, competitive position and broad resource allocation; and
- *board conformance*: internal focus on board's own performance in relation to pre-set goals of accountability to stakeholders and in relation to the business's performance.

1-2070 **BOARD DEVELOPMENT PROCESS**

To ensure that the board develops to meet the requirements of corporate performance, a conscious board development process is needed and should be watched over by the chairman. The chairman needs to promote induction, inclusion and training to improve the competence of the directors. They should also encourage discriminating questioning by the board of management and strategy, which needs strength and critical analysis. The directors should use relevant financial and other analyses to support their questions and their solutions to problems.

1-2090 **PROBLEMS FOR BOARDS**

There are some classic dilemmas facing boards. For example, boards must:

- be entrepreneurial and drive business forward while keeping control;
- understand the business, because it is answerable for its actions, but stand back to retain an objective long-term view;
- be sensitive to short-term pressures, yet stay informed of broader trends and the competition;
- stay focused on the commercial needs of the business while acting responsibly towards employees, business partners and society.

Here is one major problem area for boards:

- Directors tend to move back to their comfort zone of managing.
- They then supplant the next level down of management, who become compliant.
- This leads to blocked development and incompetence at each level.

If direction is left to powerful individuals it may lead to dysfunction of the senior management and board and may also lead to corruption and internal conflicts.

The following symptoms of corporate collapse have been identified in the Cadbury Report and other reports:

- one-person rule;
- a non-participating board;
- an unbalanced top team;
- a lack of management depth;

- a weak financial function; and
- a combined chairman and CEO role.

1-2100 **LEARNING BOARDS**

It is considered good practice for boards to become learning boards. These are boards that learn faster than the competitive environment is changing. To achieve this, boards need systems to allow comparisons with the outside environment:

- benchmarking;
- competitor analysis; and
- internal responses:
 - budgets;
 - customer satisfaction;
 - financial ratios;
 - plans;
 - policies;
 - productivity;
 - projects; and
 - strategies.

1-2110 **Customer satisfaction and 'moments of truth'**

Customers have 'moments of truth' as they interact with a company's staff or systems. The board should be asking questions such as:

- How many moments of truth do the company's customers have each day? How many are bad? Bad 'moments of truth' get amplified to other potential customers.
- How can the directors find this out?
- Why do customers buy from their organisation?
- Who are the competitors and how well do they deal with their customers' moments of truth?

Boards do not control the day-to-day running of the business and need to learn from customers and from those of their own staff who deal with customers.

They need systems to help them listen and solve problems for customers.

They must give staff who interact with customers the discretion to vary their responses to customers to fit the customers' needs.

The systems of the organisation must lead to continuous learning. Boards needs to put in place systems to develop their own people.

1-2120 **Emotional climate and performance**

The board establishes the emotional climate of the company, which determines whether or not it is acceptable to learn within the environment. The board needs to be at the centre of the organisation as its heart and brain.

The board must lead by example and be consistent, and it must be prepared to listen to the knowledge within the staff ranks. This can stop them from making the same mistakes (or bigger ones) in the future.

If learning from mistakes is not acceptable then mistakes will be covered up instead of being analysed to help the organisation learn.

1-2140 **LEARNING ORGANISATIONS**

Learning organisations require the following conditions:

- Regular time must be set aside by each person in the organisation to learn.
- Systems must measure and reward learning and move the learning towards its targets. People must be recognised for their learning.
- Encouragement must be given to continuously develop the organisation through internal and external learning.
- Learning must be valued in the performance systems and seen as an asset of the organisation.

1-2160 **THE DIFFERENCE BETWEEN THE BOARD AND MANAGEMENT**

The basic difference between the board and the executive management is their respective areas of focus. The board tends to focus on policy and strategy and the executives focus on carrying these out and on the tactics and operations of the business.

1-2180 **BOARD TYPES**

The following are the are four main types of board.

1-2190 **The non-executive board**

The non-executive board consists of non-executive directors who decide on policies and strategies which are implemented by a chief executive, who acts as the link to the business. This linking role gives the chief executive much power over the board as he or she controls the flow of information to the board members.

1-2200 **The executive board**

In this case the executives are also the board members. This type of board tends to be inward-looking and the members are similar, so there is not a diversity of views represented.

1-2210 **The two-tiered board**

The two-tiered board essentially splits the board into a supervisory (or senate) board and an operational board. The senate board directs strategy and receives performance information from the operations board, which is charged with running the business. These types of boards tend to become political and rivalry develops between the two boards.

1-2220 **The unitary board**

The unitary board has executive directors (led by the chief executive director) who are responsible for running the operations of the business, with non-executive directors ensuring accountability and independence in policy and strategy formulation and adding fresh input to board discussion and development. This type of board structure has the greatest potential for learning and self-correction.

1-2240 **THE BOARD'S ROLES AND THE SUPPORTING FINANCIAL ANALYSES**

The roles of the board have been outlined by Bob Tricker in *Corporate Governance* (London, Gower Press, 1980). These roles are:

- accountability;
- supervision;
- strategic thinking; and
- corporate policy formulation.

In the table below, the columns show Tricker's roles with some details for each role and an indication of each role's focus (internal v. external, short-term v. long-term) and then a list of references to financial analyses in the rest of this manual.

Roles of the Board	Details of Role	Cycle of Board Year	Focus	Appropriate Financial Analyses and References
Accountability	<ul style="list-style-type: none"> • Directorial audits • Legal requirements • Safeguard the interests of the company, the owners and the shareholders 	Governance review	External and short-term	<ul style="list-style-type: none"> • Shareholder value: 13-0040 • Valuations of the company: 14-0310 • Composite risk index: 5-2050 • Auditing using financial analysis: 5-3000 • Balanced scorecard: 13-0500
Supervision	<ul style="list-style-type: none"> • Budgetary control • Ensure management performance • Key Performance Indicators (KPIs) 	Operations review	Internal and short-term	<ul style="list-style-type: none"> • Factors and results: 3-0000 • Monthly financial accounts: 3-0740 • Forecasts: 5-0000 • Analysing multiple periods: 5-1020 • Setting bonus schemes to reward performance: 3-0530 • Composite risk index: 5-2050 • Ratio analysis: 6-0500 • Variance analysis: 8-0500

— *continued*

Roles of the Board	Details of Role	Cycle of Board Year	Focus	Appropriate Financial Analyses and References
Strategic thinking	<ul style="list-style-type: none"> • Corporate direction • Deciding implementation process • Market positioning • Review and deciding on key resources 	Strategy review	Internal and long-term	<ul style="list-style-type: none"> • Strategic profiling: 1-5185 • Competitor analysis and SWOT: 13-0620 • Sensitivity analysis: 6-0000 • Customer profitability: 8-0120 • Product profitability: 7-0270 • 'What if' analysis: 4-0020
Corporate policy formulation	<ul style="list-style-type: none"> • Purpose • Vision and values • Corporate culture and climate • Monitoring external environment 	Strategy review	External and long-term	<ul style="list-style-type: none"> • Competitor analysis: 13-0620 • Benchmarking performance: 7-0450 • Pricing strategies evaluation: 10-1090 • Planning to fund growth: 12-0500 • Cost reduction strategy: 12-5000 • Dividend policy: 12-2000 • Cost of capital management: 13-0160 • Advanced cost management: 13-5000 • Process re-engineering: 13-5340

1-2260 **CONCLUSION**

The role of boards and the use of financial analysis and cashflow techniques are critically interlinked. Boards need to direct their businesses by creating strategies, which must be assessed through financial analysis techniques to ensure that they will result in appropriate financial results if successful. Boards also need to monitor performance, be accountable to shareholders, engage in strategic thinking and develop corporate policy. All of this demands a wide range of financial analysis techniques and skills to assist the boards in making decisions, contemplating possible courses of action, and developing an understanding of the dynamics of their organisations. This need for supporting financial analysis is the reason that there are so many simple platforms such as the one page analysis format, which is used in many of the analyses in this manual (see para. 3-0990). This standard analysis format is used by many directors of companies, senior managers and business advisers to see results and factors, to carry out ‘what if’ analyses, to construct sensitivity matrices, to forecast results and generally to see the dynamics of their profit and loss, balance sheets, returns and cashflow.

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