The Complete CFO Handbook

From Accounting to Accountability

FRANK J. FABOZZI
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FJF
To my wife, Donna, and my children,
Karly, Patricia, and Francesco

PPD
To my husband, Randy

RSP
To my inspiration, Maxine Elko

Contents

Preface

The role of financial executives in any business has expanded significantly in recent years as companies become more accountable to their stakeholders and regulators. Combine this increase in accountability with the increasing sophistication of technology, risk management, financial analysis, and financial records processing, and we see that the responsibilities of financial executives in any organization have expanded significantly.

Our goal with *The Complete CFO Handbook* is to provide financial executives with the background and tools for managing a company's financial functions. The *Handbook* consists of five parts, each focusing on a different dimension of the financial executives' role.

In Part One we focus on funding issues, including the capital structure decision, the choice of debt financing, equity financing issues, and structured financings. We include the traditional capital structure theory and analysis, but our focus really is on the analysis of what companies do in practice. To this end, we include coverage of:

- How the Sarbanes-Oxley Act of 2002 affects the responsibilities and the role of the CFO.
- The governance value of debt financing.
- Costs of financial distress.
- Factors to consider when designing a bond issues.
- Alternative methods of repurchasing stock.
- Structured finance transactions.
- Credit enhancement in securitization.
- Structured notes.

In Part Two we address strategic planning, taxes, and risk management. The CFO is often playing a larger role in developing and executing the company's strategic plan, which means taking a broader view of the sources of value creation and of the company's risk management strategies. We include coverage of current issues to help the CFO better prepare for this broader view:

- Sources of value creation.
- The relation between economic value added and the balanced scorecard to strategic planning.

- Tax risk management.
- Transfer pricing and thin capitalization.
- Enterprise risk management.
- Retention risk management.
- Risk transfer management.

In Part Three we focus on performance evaluation, providing analysis tools for financial analysis that includes cash flow analysis and the analysis of budget variances. We include tools and topics to help the CFO analyze different dimensions of performance:

- DuPont system of analyzing return on investment ratios.
- Free cash flow and discretionary cash flow analysis.
- Responsibility accounting.
- Performance reports.
- Flexible budgets.
- Variance analysis.
- Transfer pricing systems and related tax issues.

In Part Four we look at asset management, which includes long-term and short-term asset management. With respect to long-term asset management, we examine traditional capital budgeting methods, including estimating cash flows and applying valuation techniques. In addition, we take a look at how capital budgeting is applied in practice. The CFO faces an array of asset management techniques and tools. To help prepare the CFO for this array, we include coverage of:

- Adjusted present value method.
- Real options applied to capital budgeting.
- Tax and non-tax-oriented leasing.
- Leveraged leasing.
- Cash conversion cycle analysis.

In Part Five we cover the traditional managerial accounting topics of classifying costs, job order costing, direct and absorption costing, and standard costing. The costing methods are fairly detailed and we have summarized the primary methods. In addition, we include coverage to help the CFO gain a perspective on these costs, including:

- The relation between costs and planning, controlling, and decision making.
- Activity-based costing.

- Process costing.
- Costing for by-products.
- Comparison of direct and absorption costing.
- JIT management and the costs of manufacturing.
- The interrelationships among the different budgets within a company.

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CHAPTER 1

The Changing Role of the CFO: From Accounting to Accountable

JOB DESCRIPTION: Oversee financial accounting systems, reporting, and disclosures; assure compliance of financial reporting with generally accepted accounting principles and securities law accounting requirements; assure compliance with local government, federal government, and international tax laws, regulations, and rules; expert in disclosure compliance with federal and state securities laws; establish, monitor, and evaluate internal controls; work with the CEO in the development of the strategic goals and plans, execute the strategic plans, and evaluate performance relative to the strategic goals; participate in long-term and short-term budgeting; exceptional communication and team leadership skills; able to raise capital and manage the firms' capital structure to maximize the value of the company and minimize the company's cost of capital; develop, monitor, and evaluate a program of risk management; communicate with the company's Board of Directors, shareholders, creditors, and credit rating agencies; no sensitivity to the effects of kryptonite.

Many years ago, the role of the *chief financial officer (CFO)* was to keep the financial records, and had accounting, internal control, budgeting, and treasury responsibilities. But the role has changed over the years to be much more comprehensive and to include decision-making that extends beyond the accounting and treasury functions. The CFO of today is responsible for measuring and monitoring performance, but the CFO is also now involved in managing risk and creating value for owners.

What has caused this change? There is not just one cause; but rather several forces that have resulted in the expanded role of the CFO. In the 1990s, we saw the role expanded from financial accounting and accounting systems to include financial analysis and an active role in strategic planning.[1] This expanding role is apparent in the Chief Financial Officers Act of 1990, which

[1] *The Practice of Management Accounting*, Institute of Management Accountants (Montvale, NJ, 1996), and *Reinventing the CFO: Moving from Financial Management to Strategic Management*, Coopers and Lybrand (New York, 1997).

specifically addressed the changing role of the CFO in federal government entities.[2] In the 1980s and 1990s, with the continued globalization and technological innovations, the CFO in some companies became a starring role as a deal-maker who sought out growth opportunities for the company.

The role of the CFO widened further because of the financial scandals of the 1990s and early 2000s that included Enron, WorldCom, and, unfortunately, many more companies. The resultant changes in laws and regulations focused attention on the CFO and broadened the responsibilities of this position. This resulted in a renewed emphasis on the CFO's role in accounting and financial reporting, but also added responsibilities for restoring confidence in the integrity of the company's financial accounting, internal control systems, and risk management.

Throughout this book, we discuss the responsibilities of the CFO in an organization. We recognize that in large companies the responsibilities of the CFO may be shared with the controller, a vice-president of finance, the corporate treasurer, a chief risk officer, or some other, similarly titled individual. However, in referring to the CFO, we are referring to responsibilities of the financial officer with the ultimate responsibility for the financial decision making of a company, responsibilities that may be shared or split among persons in the organization.

SOX ACT OF 2002 AND THE CFO

The *Sarbanes-Oxley Act of 2002* (SOX Act) is the most wide-sweeping legislation to affect the securities industry since the Securities Act of 1933 and the Securities Exchange Act of 1934.[3] The SOX Act was passed as a reaction to the failures of corporate governance that were pronounced in scandals such as Enron.[4] The SOX Act affects many participants in our financial markets: investors, security analysts, corporate management, and accountants. The Act includes provisions to increase internal monitoring, regulate the gatekeepers (e.g., chief executive officer, CFO, and the board of directors), penalize insider misconduct, and increase transparency.

We summarize the key provisions of this Act in Table 1.1. The SOX Act came about following numerous financial scandals that involved publicly

[2] The role of the CFO, as expressed in the Chief Financial Officers Act of 1990 [Public Law 101-576], was expanded by the Government Management Reform Act of 1994 [Public Law 103-356].

[3] Public Law 107-204, July 30, 2002.

[4] For an overview of the failures in the case of Enron, see William C. Powers, Jr., Raymond S. Troubh, and Herbert S. Winokur, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp*. (February 1, 2002), 2002 WL 198018 ("Powers Report").

TABLE 1.1 Key Provisions of the Sarbanes-Oxley Act of 2002

Title I	Public Company Accounting Oversight Board ■ Establishes the oversight board, as well as provides policies and procedures for registration of accounting firms. The purpose of the board is to provide oversight of auditing firms and develop standards for auditors, auditing, and auditing reports, as well as to inspect accounting firms for compliance [Sec. 101].
Title II	Auditor Independence ■ Prohibits most types of non-audit services of client by auditing accounting firm [Sec. 201]. Any non-audit service by an auditor must be approved by the audit committee of the client [Sec. 202].
Title III	Corporate Responsibility ■ Requires that members of the client's audit committee be independent (i.e., not an employee of the client or consultant or adviser other than in capacity as a member of the board of directors.) [Sec. 301]. ■ Requires certification of the annual and quarterly filings with the SEC by the chief financial officer and the chief executive officer, attesting to the internal controls of the firms [Sec. 302]. ■ Prohibits improper influence on audits [Sec. 303]. ■ Specifies forfeiture of bonuses and profits on securities in the event of financial restatements [Sec. 304]. ■ Prohibits insider trading during pension fund blackouts and requires sufficient communication to fund participants and beneficiaries in the event of a blackout period [Sec. 306].
Title IV	Enhanced Financial Disclosures ■ Enhances disclosure of off-balance-sheet transactions [Sec 401]. ■ Requires reconciliation of pro forma financial information with results according to generally accepted accounting principles [Sec. 401]. ■ Prohibits many types of personal loans to directors or executives [Sec. 402]. ■ Increases disclosure requirements for transactions with directors, executives, and principal shareholders [Sec. 403]. ■ Requires disclosure of whether the firm has a code of ethics for financial officers [Sec. 406]. ■ Requires disclosure of whether there is at least one financial expert on the audit committee [Sec. 407].
Title V	Analyst Conflicts of Interest ■ Increases the independence of analysts and investment banking activities and requires disclosure of potential conflicts of interest of analysts [Sec. 501].

TABLE 1.1 (Continued)

Title VII	Studies and Reports ■ Requires studies of the accounting industry [Sec. 701], the credit-rating industry [Sec. 702], violators of securities laws, enforcement actions [Sec. 704], and investment banks [Sec. 705].
Title VIII	Corporate and Criminal Fraud Accountability ■ Imposes criminal penalties for destruction of documents [Sec. 802]. ■ Provides whistleblower protection in fraud actions [Sec. 806]. ■ Provides criminal penalties for defrauding shareholders [Sec. 807].
Title IX	White-Collar Crime Penalty Enhancements ■ Provides increased criminal penalties for white-collar crimes, such as mail and wire fraud [Sec. 902]. ■ Imposes criminal penalties for false certification of financial reports [Sec. 906].
Title XI	Corporate Fraud and Accountability ■ Imposes fines and possible imprisonment for tampering with documents in an investigation [Sec. 1102]. ■ Provides the SEC with authority to freeze payments in the event of an investigation [Sec. 1103].

traded corporations, accountants, investment bankers, and brokers, with most of the provisions of the SOX Act traceable to specific misdeeds. For example, the provision for the reimbursement of bonuses prevents lucrative exits of executives from companies that were involved in accounting misstatements, such as those that occurred at Gateway.[5] As another example, the provision for the independence of the audit committee members from management of the company prevents management from participating in the dealings with auditors, which was a problem in the case of Adelphia Communications.[6]

The provisions of SOX 2002 that directly affect the CFO include the following:

- *Section 206:* This section reduces potential conflicts of interest by making it unlawful for a CFO, CEO, controller, or equivalent officer to have

[5] *Securities and Exchange Commission v. John J. Todd, Robert D. Manza, and Jeffrey Weitzen*, Complaint for Violations of the Federal Securities Laws.

[6] Adelphia's audit committee at the end of 1999 comprised three members: Perry Patterson, Pete J. Metros, and Timothy J. Rigas, and was charged with the responsibility of monitoring and financial reporting for investors and the board of directors (Adelphia Communications Corporation Definitive Proxy Statement, Schedule 14A, filed July 7, 2000). However, Rigas was the company's executive vice president, CFO, chief accounting officer, and treasurer, which means that he was responsible for monitoring himself.

been employed by the independent public accounting firm and have participated in the audit of the company within one year of the audit.[7]

- *Section 302:* This section requires the CEO and CFO, or equivalent officers, to certify annual and quarterly reports and, in signing, they are responsible for the establishment and maintenance of internal controls. By certifying, they are also attesting to have reported any deficiencies to the auditors and the Audit Committee of the Board of Directors.
- *Section 304:* This section permits the Securities and Exchange Commission (SEC) to sue for forfeiture of any incentive-based, equity-based, or other bonus compensation of management in the event of a restatement of financial statements due to noncompliance. This provision deters management from manipulating reported financial accounting results for personal benefit.[8]
- *Section 401:* This section requires that periodic financial reports not only be presented accurately but be presented in a manner that includes incorrect statements or fails to state material information. It also requires that the issuer disclose material off-balance sheet transactions,[9] contingent obligations, and other relationships between the issuer with unconsolidated entities such as special-purpose entities.[10]
- *Section 404:* This section requires disclosure of management assessment of internal controls and independent public accounting firm attestation of management's assessment. The requirement of reporting on internal controls imposed substantial startup costs on companies. More important, however, is the fact that this section creates a liability risk that is borne by the CEO and CFO. That is, the auditing firm and the executives signing off on the internal control report bear the liability for any failing in the internal control system.[11]
- *Section 409:* This section requires real-time, plain-English disclosures of material changes in the company's operations or financial condition. The effect of this is (1) an expansion of the number of events that require a company filing a Form 8-K under the Securities and Exchange

[7] Amendment to Section 10A of the Securities and Exchange Act of 1934.

[8] However, as determined in the courts, this is a disgorgement action that must be brought by the SEC, not private parties [*Neer v. Pelino*, No. 04-CV-04791-SD (E.D. Pa. September 27, 2005)].

[9] We discuss off-balance-sheet transactions in Chapter 3.

[10] We discuss special-purpose entities in Chapter 5. Enron used these entities to create misleading financial statements.

[11] This increased liability risk may affect the risk-taking behavior of these executives, as suggested by Daniel A. Cohen, Aiyesha Day, and Thomas Lys, "The Sarbanes Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs," Working paper, July 8, 2005.

Act of 1934 from 9 to 22, and (2) a shortening of the deadline to four business days.[12]

- *Section 906:* This section requires certifications of audit reports by CEO and CFO with respect to compliance with securities laws and that the information represents fairly the financial condition and operating performance of the company. Criminal penalties are possible for certifications when in noncompliance.

EXPANDED RESPONSIBILITIES OF THE CFO

The broadening of responsibilities of the CFO has made this role less of a reactive, purely financial function, and more of a proactive role in the company's future, participating in many dimensions of the company's decision-making.

Traditionally, the CFO's responsibility related to accounting and treasury tasks. The traditional accounting functions included budgeting, forecasting, financial reporting, and performance measurement. Therefore, the CFO must be familiar with financial accounting, management accounting, and budgeting, and have an ability to communicate this information internally, as well as to creditors, shareholders, and others. The traditional treasury functions include capital structure decisions and investment decisions. Investment decisions include both working capital management as well as long-term capital investment, and require the CFO to be well versed in valuation principles.

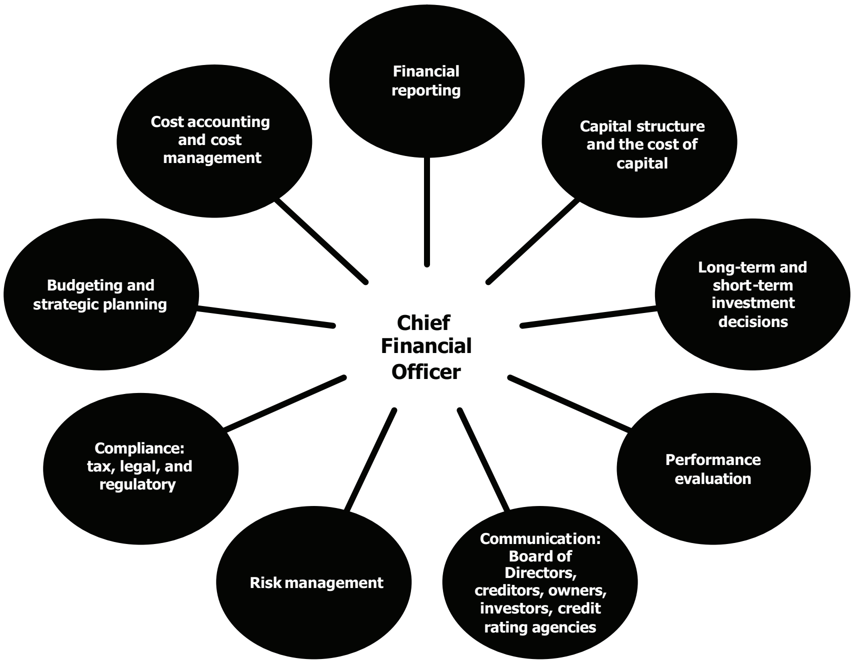
The expansion in the role of the CFO includes compliance, risk management, communications, and performance evaluation. This expansion adds to the complexity of the role of the CFO, requiring an expanded knowledge of laws, rules, and regulations, an understanding of risk and the ability to communicate risk both internally and externally, and an ability to evaluate performance, using such tools as the balanced scorecard, economic value added, and other metrics. We illustrate the nexus of CFO responsibilities in Figure 1.1.

Compliance: Tax, Legal, and Regulatory

The compliance obligations of the CFO become more complicated as laws, regulations, and rules are created or change. For example, the CFO is re-

[12] *Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Securities and Exchange Commission [17 CFR Parts 228, 229, 230, 239, 240, and 249, RIN 3235-AI47].

FIGURE 1.1 The CFO's Responsibilities



sponsible for expertise in laws, regulations, and rules that affect financial reporting, risk management, and the management of internal controls. The laws, regulations, and rules that the CFO must be familiar with include:

- Securities and Exchange Commission reporting requirements and regulations.
- Compliance with Sarbanes-Oxley Act of 2002.
- U.S. and international generally accepted accounting principles (GAAP).
- Internal Revenue Service reporting requirements and regulations.
- Compliance with U.S. Foreign Corrupt Practices Act (FCPA).[13]

Additionally, depending on the type of business, other laws and regulations may be relevant. These laws, regulations, and rules are all part of the responsibilities of the CFO, though many of these responsibilities may be shared with the controller.

[13] Some of the challenges imposed by this law and the interaction with SOX Act of 2002 are in Tom Leander, "In China, You Better Watch Out," *CFO Asia*, March 20, 2006.

Additionally, the CFO must be aware of the changes that are on the horizon to effectively plan and forecast. For example, U.S. accounting standards are converging with International Financial Reporting Standards (IFRS) as the Financial Accounting Standards Board and the International Accounting Standards Committee (IASC) work out the differences in these standards. These changes in accounting standards affect financial reporting and may affect financial decisions. As another example, securities laws are tightening in a reactive manner to financial or accounting misdeeds and the CFO must grapple with the implications of these changes to financial disclosures and financial planning.

Communications

The CFO's role in company communications has changed such that the CFO is now an important player in communicating with the company's stakeholders—the creditors, shareholders, and others—not only the financial condition and operating performance of the company, but the risks and strategies of the company. The increased demand for transparency has expanded the type of information disclosed and the method of disclosure. Companies are now required to make real-time disclosures of material company events, which increases the pressure to provide accurate, current information. A number of the disclosures that U.S. publicly traded companies must make are summarized in Table 1.2.

The acceleration of the speed of disclosures began with Regulation FD. In an attempt to "level the playing field," the Securities and Exchange Commission in 2000 adopted new rules regarding selective disclosure.[14] These rules, in the form of the Fair Disclosure regulation (Regulation FD), require that if a publicly traded company or anyone acting on its behalf makes material, nonpublic information available to certain persons, the company must make a *public* disclosure of this information. All intentional disclosures are simultaneously to the public—not filtered through analysts, which was the previous custom. Now, if someone makes an *un*intentional disclosure, the company is required to make a prompt, public disclosure of the information. Regulation FD, combined with the real-time disclosures required under the new rules for 8-K filings due to the SOX Act of 2002, creates pressure on the CFO to be both fast and accurate.[15]

[14] Securities and Exchange Commission, RIN 3235-AH82, "Selective Disclosure and Insider Trading," effective October 23, 2000.

[15] The significance of the communications and compliance burdens on the CFO is evident in recent surveys of CFOs. See, for example, Stephen Taub, "Survey: Sarbanes-Oxley Making CFO Job Tougher," *CFO.com*, March 10, 2003, based on a survey by Deloitte Consulting and *BusinessWeek*.